

**PROPOSED SOLUTIONS FOR THE CAPITAL FUND-
ING NEEDS OF START-UP AND EMERGING
GROWTH BUSINESSES**

HEARING
BEFORE THE
SUBCOMMITTEE ON TAX, FINANCE, AND EXPORTS
AND
SUBCOMMITTEE ON WORKFORCE, EMPOWERMENT,
AND GOVERNMENT PROGRAMS
OF THE
COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES
ONE HUNDRED SEVENTH CONGRESS
FIRST SESSION

WASHINGTON, DC, JUNE 26, 2001

Serial No. 107-15

Printed for the use of the Committee on Small Business



U.S. GOVERNMENT PRINTING OFFICE

74-304

WASHINGTON : 2001

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: (202) 512-1800 Fax: (202) 512-2250
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PROPOSED SOLUTIONS FOR THE CAPITAL FUNDING NEEDS OF START-UP AND EMERG- ING GROWTH BUSINESSES

TUESDAY, JUNE 26, 2001

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
SUBCOMMITTEE ON TAX, FINANCE, AND EXPORTS,
SUBCOMMITTEE ON WORKFORCE, EMPOWERMENT
AND GOVERNMENT PROGRAMS,
Washington, DC.

The subcommittee met, pursuant to call, at 2:05 p.m. in room 2360, Rayburn House Office Building, Hon. Pat Toomey (chairman of the Subcommittee on Tax, Finance, and Exports) presiding.

Mr. TOOMEY. The subcommittee will come to order.

In light of the fact that we have a vote, I believe we have two votes right now, I will adjourn the hearing. We will do the votes, come back as quickly as we can and then get underway and hopefully we will have time to get through this uninterrupted from there, but no promises. So the meeting is adjourned for now.

[Recess.]

Mr. TOOMEY. The meeting will come to order. I would like to thank everyone for their patience as we went through the votes. It is my understanding that we do have some time now before any subsequent votes, so hopefully we will be able to get much of this done.

This afternoon, the Small Business Subcommittee on Tax, Finance, and Exports convenes in a joint hearing with the Subcommittee on Workforce Empowerment and Government Programs to address an important challenge facing small businesses throughout the nation and that is access to capital.

This hearing follows the full committee hearing conducted on May 17, 2001 which focused on results from a Federal Reserve U.S. bank survey which supported evidence of tighter loan standards for businesses attempting to obtain commercial and industrial capital.

Capital is, of course, the lifeblood of small businesses. For a citizen with a dream of becoming an entrepreneur, a small business owner looking to more efficiently bring goods and services to the marketplace, or a small or mid-size business attempting to maintain profitability, access to capital is imperative for growth, in many cases, for survival.

There are a number of potential solutions to the shortage of capital for small business and I want to especially recognize and thank my colleagues Mr. DeMint and Mr. Baird for their work in crafting

legislation that might very well substantially alleviate some of these problems. Let me just briefly touch on the SUSa act and the BRIDGE act.

The SUSa stands for the Start-Up Success Accounts. This is an act that would allow small businesses with gross receipts of up to \$2 million to deduct and place up to 20 percent of taxable income into an account for each of the first five years of a business operation. If enacted, this legislation would allow small businesses to draw down on the funds from these accounts over a five-year period from the time of deposit, thereby stabilizing the flow of capital and equipping the start-up to save for the future.

The BRIDGE act would allow a firm experiencing sales growth of 10 percent or more to temporarily defer a portion of its federal income tax liability.

Both of these measures could be extremely helpful. Clearly the two gentlemen who worked together in developing this legislation understand the challenges facing small business and I commend them for the creative approach they have taken to addressing this challenge.

On a personal note, I would like to suggest that I think one of the most effective ways that we can help facilitate small business access to capital would be providing relief from the capital gains tax. Personally, my conviction is that we ought to eliminate the capital gains tax all together. That serves as an impediment which is an obstacle to small business and all business attracting capital. It is a punishment for people and businesses that save and invest and therefore it deters economic growth. Having said that, this solution is in no way exclusive as an approach to helping business access capital.

I think Messrs. DeMint and Baird have some very good suggestions as well.

I would also just remind everyone how critical small business is to our nation's economy. It has been the cornerstone of our economy for decades. Small businesses continue to provide so many critical job opportunities and access to the American dream for so many folks. That is why I think it is very important that we have this hearing today, that we hear from the folks who are on the front lines actually operating small businesses.

I look forward to the testimony of all of our witnesses today, but I want to particularly thank those of you who have traveled a long distance to be with us, in particular, my friend and constituent Mr. Brinson, who is here from the Lehigh Valley, a small business owner, who has a great deal of expertise in this area.

At this point, I will yield to my good friend from South Carolina, Mr. DeMint.

Mr. DEMINT. Thank you, Chairman Toomey. I appreciate as well the opportunity to join with you in bringing these two subcommittees together today to examine more closely some of the issues and questions raised at the full committee hearing on access to capital earlier this year.

Inc. Magazine commented in its annual State of Small Business issue this year that "If small business were a boxer, the blows of the past 12 months might have left it on the ropes." That same

issue cited financing as the second largest reason for small business bankruptcy.

The overall problem of access to capital and capital retention is what we are focused on here today. However, those challenges manifest themselves differently for start-up companies and for emerging growth businesses. From a public policy standpoint, I am pleased that we have the opportunity to examine the different financing needs of these types of businesses and explore legislative solutions.

New businesses have the potential to create hope and opportunity for many Americans. They are an integral part of the renewal process that defines market economies. New and small firms play a crucial role in experimentation and innovation which leads to technological change and productivity growth.

They also provide an essential path for many to enter the economic and social mainstream of society. Small business is the vehicle by which millions access the American dream by creating opportunities for women, minorities and immigrants. In fact, minority and women-owned businesses make up two of the fastest growing segments of new small businesses.

While this is encouraging, a large number of these new businesses fail in the first few years, often for a lack of capital. A primary cause of this is that our tax code does much to discourage capital retention. The ultimate result is the loss of staying power. Operating with no capital, even in a small downturn in sales can put a new company out of business.

Earlier this year, as Chairman Toomey mentioned, Representative Baird and I introduced H.R. 1923, the Start-Up Success Account Act of 2001 which we call SUSA. The purpose of this legislation is to give new small businesses an additional tool to manage finances and retain capital. H.R. 1923 would allow a start-up to place up to \$100,000 of taxable income into a SUSA account over the course of the first five years of business operation. This would allow new businesses, new small businesses, that are profitable in one year to set aside some profits to prepare for a downturn in later years.

This bill is similar to a bill by our colleague, Kenny Hulshof, which would help farmers and ranchers manage capital with FARRM accounts.

Fewer people may be familiar with the emerging growth businesses that we will also discuss today that are crucial to the U.S. economy. Emerging growth businesses are a precious national asset. They are America's job generator, producing over 90 percent of the net new employment in the last 10 years. Evidence also indicates that they are the only firms that provide new jobs during suppressed economies, like the present one.

Emerging growth companies confront a unique threat in the area of obtaining and retaining capital and ironically are most vulnerable to failure in the period in which they are quickly expanding. Although seemingly counter intuitive, when these firms enter a high growth phase and are experiencing increased profits under accrual accounting standards, they often face transitional cash flow shortages or negative cash flow due to the need for increasing investment in working assets and new personnel as sales expand.

The tax code compounds the difficulty in retaining capital during the high growth phase because it forces an expanding business to pay taxes on accrued income during this period of cash shortfall.

Because these firms are not big enough to attract outside asset-based financing, they fall into a capital funding gap. The result is that emerging growth companies may not generate sufficient cash flow even as they enter their profitable years to cover income tax liability. This capital funding gap has a measurable and detrimental impact on the U.S. economy.

To help resolve this capital funding problem for emerging growth businesses, Congressman Baird and I have been working closely with Doug Tatum, who you will hear from today, on what we call the Business Retained Income During Growth and Expansion Act or BRIDGE which we hope to introduce within the next few days or weeks. In order to provide emerging growth firms with needed capital cash flow as they expand sales revenue, the BRIDGE act will allow a firm that meets the growth test to temporarily defer a portion of its federal income tax liability.

The deferral would be limited to \$250,000 of tax, which would be repaid with interest. The tax-deferred amount would be deposited into a separate BRIDGE account at a bank and the firm could use the account as collateral for a business loan from the bank.

Now, this proposal could bring tremendous national benefits as a way to create a significant job creating sector of the economy. We anticipate the BRIDGE would also have a modest revenue effect initially which would become neutral over a long period of time.

As one who owned a small business before coming to the House, I am aware of the devastating effect that capital shortage can have on a business.

I, too, would like to thank all of the panelists and yield the time back to the chairman.

Thank you.

[Mr. DeMint's statement may be found in appendix.]

Mr. TOOMEY. Thank you, Chairman DeMint.

At this time, I will yield for five minutes to the ranking member, Mr. Pascrell.

Mr. PASCRELL. Thank you, Mr. Chairman. I think this is a great joint hearing whose purposes I absolutely support.

The access to capital hearing is particularly timely, given the nation's current economic uncertainty. The economic boom is slowing down, I think we would all agree. Financial losses are mounting for many companies and job cuts are affecting every industry in America. To make things worse, in recent weeks we have read studies that suggest the tightening of credit standards by a variety of banks. This is a real problem.

Small businesses need convenient access to capital resources and that is our primary job, I would think, on all of the committees, all of the subcommittees, whether it is start-up costs, expansion purchasing or employee costs, there are always new expenses for businesses.

And small businesses certainly need financing in order to stay competitive with larger companies in the marketplace—we have heard that over and over again in the last few weeks—because tra-

ditionally many small businesses have limited assets and uncertain earnings. That is one thing for sure.

Because of this, they have a more difficult time than larger companies when it comes to finding the financial fuel to make their ventures successful. The tragic result is that these small companies, particularly minority and women-owned businesses, with enormous potential end up closing their doors due to lack of capital.

So I welcome the hearing and I welcome hearing the various proposals before this subcommittee that address these issues. With access to capital issues on our mid, let us not forget that we must make certain that as Congress debates funding priorities for the next fiscal year we include a comprehensive discussion on the impact of these decisions upon the small business community, particularly given the Bush administration's proposed cuts in 7(a) and small business investment companies programs, a proposal which eliminates the program appropriations for each loan program and replaces them with fees. Unacceptable.

I thank you for coming here today and I thank the chairs and I look forward to a lively discussion.

Mr. TOOMEY. I thank the gentleman from New Jersey.

At this time, if he has an opening comment, I would like to recognize for five minutes the gentleman from Washington who has been participating in the drafting of this legislation, Mr. Baird.

Mr. BAIRD. I thank the co-chairs and the ranking member.

Just very briefly, my good friend and colleague Jim DeMint, I think well described the situation. It was pointed out to me first, before I was elected, I put together a panel of small business folks and asked what is the number one thing we could do and what they pointed out to me was there are a lot of government programs to help businesses get on their feet, but as we know, high percentages of brand new start-up businesses have a failure rate.

The real jobs, as Congressman DeMint mentioned, are the jobs from the existing businesses that have been successful enough to start growing, yet paradoxically we have almost no government programs to help provide capital or support for fast growth businesses and yet the private sector, for reasons described well in our previous hearing, often cannot make up that gap.

It is as if we give people a car but then we put a governor on the accelerator. Just as you try to move forward, the governor takes in and puts the brakes on. That lack of capital is the governor and I think the SUSA act that Congressman DeMint and I have already introduced combined with this BRIDGE act, if we can get it passed, would go a very long way toward providing incentives and support for small businesses and that would enhance employment and I commend the chairs for their efforts and I look forward to the testimony of the panelists.

Thank you.

Mr. TOOMEY. Thank you, Mr. Baird.

Ms. NAPOLITANO, do you have any opening comments?

Ms. NAPOLITANO. Only that it is one of the most salient issues in my area in dealing with small businesses' ability to succeed. Myself being in small business many years ago, that was one of the

issues we encountered, is the assistance from being able to move forward and grow.

I was reading one of the reports that it indicates that small business has been the engine of the economy of 50 percent. I would venture to say it is over 75 percent. And I think we are not giving small business its due and the assistance it needs to be able to have the growth, the potential it has. And I think the more we hear about the issues directly from small business that we can then be able to move forward with an agenda, with legislation that is going to really impact and have the ability to help small business growth through assistance in funding.

Thank you.

Mr. TOOMEY. Thank you.

At this time, I will recognize Ms. Millender-McDonald.

Do you have an opening comment?

Ms. MILLENDER-McDONALD. Yes. Thank you, Mr. Chair.

And to both chairs, as one of the ranking members who are poised to convene this hearing, we understand and recognize that the impediment to growth and expansion of any small businesses is that of access to capital. And so we also recognize that there is a lack of access to capital with reference to small businesses. Today, our hearing focuses on such a lack.

Recent studies have documented that the greatest growth in employment has resulted from small businesses with less than 100 employees. In order for small businesses to grow, we have to expand so that we can employ folks. And with my position on workforce and empowerment, it is critical that we look into access to capital.

Mr. Chairmen, I will not read my statement, but merely ask unanimous consent that we place this in the record and I look forward to the testimonies today.

Mr. TOOMEY. Without objection.

[Ms. Millender-McDonald's statement may be found in appendix.]

Mr. TOOMEY. Does the gentleman from Ohio have an opening statement? No?

Okay. In that case, we can begin with the testimony. I would just like to briefly explain the clock system we will use. Everybody will be operating on a five-minute rule. The light will be green for the first four minutes. It will go yellow with one minute remaining and we will try to stick to that so we can move things along.

At this point, I would like to recognize Mr. Brinson from Lehigh Valley, Pennsylvania.

STATEMENT OF JOHN BRINSON, PRESIDENT, LEHIGH VALLEY RACQUET & FITNESS CENTERS, ALLENTOWN, PENNSYLVANIA

Mr. BRINSON. Thank you, Congressman Toomey, Congressman DeMint, Congressman Baird, and all the rest. I know some of you.

I know Pat very well, I have known him since before he ran for Congress and he used to work out in my clubs on a pretty regular basis, but he tells me he is too busy to work out now.

Mr. TOOMEY. Occupational hazard.

Mr. BRINSON. Yes. Yes.

I am chairman, CEO and majority owner of a small business in the Lehigh Valley of Pennsylvania and without going through all

my testimony in detail, our business has four locations. We have 10,000 members and we employ 300 people, 45 of them full-time employees and 250 plus are part-timers.

We have had a good record. We have basically been with the same bank for 22 years. The problem that I want to talk about today has to do with access to capital for expansion. Back in 1998, I began to talk—and our bank is First Union and, by the way, I have to say for the record I am very pleased with First Union Bank, if there are any First Union Bank employees in the room, I love First Union. And, honestly, I am not here to say anything disparaging about the bank. We have a very good relationship with them and we have had a very good relationship with them.

In 1998, I told them that the west end of our market was expanding rapidly and that we needed a new location. They were cool. They said, well, “let us see your proposal”. I gave them a proposal for a new club to be located about five miles to the west of our westernmost club at the time. We have sort of a linear market in the Lehigh Valley.

Anyway, I suggested that they lend us \$500,000 and we would put up \$300,000 or whatever else was necessary to do the club.

They passed it up the line, the answer was no.

I went back and I asked again, the answer was no.

I asked why, and they said, “well, it is because, you know, your business is a high risk business and we have enough risk and we do not want any more risk”.

And so they turned us down.

So I told them that we would go to another bank and see what we could do and they said, “well, you cannot do that because of loan covenants”.

We have a large mortgage with First Union Bank and they have covenants upon covenants. I mentioned before the meeting to a couple of reporters that I need to call them to get permission to go to lunch. They really—it is almost like—the lawyers would understand, a contract of adhesion. If you want the money, you are going to sign away your life and permission to do anything and everything.

Anyway, they told me I could not go to another bank.

So I said, well, “I will round up a new group of owners”.

And they said, well, “it cannot include you, so you will have to find a new group of owners not including yourself”.

And I said, well, “all right, I will do that”.

And they said, “you still cannot do it because your existing clubs cannot have anything at all to do with the new club”.

But, of course, the reason we wanted the new club was to have it be a part of our chain.

So they tried to stop us at every turn.

Anyway, I sat down with my lawyer and we read the loan covenants and we found a way around it and we did it anyway. We went out and we raised all the money without one single penny of bank money from private investors, none of whom own any part of our existing business. And so we have a new club. I do not own a penny’s worth of it and we are managing the new club under a management contract.

It is a good deal for us to do this, but I sure wish the bank had participated.

I want to say that I think the reason the bank did not was because bank regulations are extremely difficult. They have all kinds of ratios and tests to meet, they have all kinds of businesses that are classified as high risk and medium risk and so forth and so I think bank regulation is a big problem.

As I mentioned in my testimony, I would like to see some provision for income taxes to be deferred to help business such as ours with expansion.

Thank you very much.

[Mr. Brinson's statement may be found in appendix.]

Mr. TOOMEY. Thank you, Mr. Brinson.

At this time, I would like to recognize the founder and chief executive officer of People Solutions, Inc., Mr. Ed Rankin, our next witness, for his testimony.

**STATEMENT OF ED RANKIN, FOUNDER & CEO,
PEOPLESOLUTIONS, INC., IRVING, TEXAS**

Mr. RANKIN. Thank you, Chairman Toomey, Chairman DeMint and members of the subcommittee. My name is Ed Rankin. I am the founder and chief executive officer of PeopleSolutions. We are a Dallas based company. We have offices in Austin and Houston.

We were an early entrant into a disruptive industry, disruptive in terms of we are changing how American industry, U.S. industry, is managing people and we are really providing a more efficient relationship between people and their employer through this human resource management outsourcing industry.

This is a complete start-up. I went to the bank on February 14, 1994. I remember it because it was Valentine's Day. And I deposited \$1000 into a commercial bank, a large regional commercial bank, and we started the business in an executive suite office with an ink jet printer and a notebook computer and some borrowed furniture.

The first year, we did about three or four hundred thousand dollars in revenue. We were profitable. We started to get feedback from our clients that this was real and we got some large corporations as clients, large multi-nationals who were asking us for more and more work. We started investing in the business a little.

In the second year, in 1995, we did slightly more than \$1 million in revenue. And all through this time period we had been very profitable. Our profit margins were strong, our net income was good, we were running about 10 percent net income, which we probably could have done much better, but I was trying to grow and we were growing at 100 percent a year.

I tried during this time period to get loans from commercial banks, just for growth. There was nothing there. No one even wanted to talk with us. Literally, banking officers would not even return calls.

The third year, we really, really took off. And our workforce is predominantly well educated, highly paid people. I have many people working for us that earn more than \$100,000 a year. We are some creating really good jobs for people. In the third year, we had to invest again. We were ranked among the 25 fastest growing pri-

vately held companies in the Dallas-Fort Worth area. Again, we were profitable. Our revenues exceeded \$2 million. So we went from a half million to a million to two million. But I had no cash. I literally had no cash.

Some of our clients, the large companies, were paying us in 30 days, some were paying 45, some would pay in 60. No bank would lend money to me, even though these were large international corporations because we were young and the loan was considered too risky.

Unbeknownst to me, the woman who was acting as controller failed to pay my employment taxes because, as she told me later, "well, we just did not have the money". "I told her, you know, that really is not an optional thing, we probably have to go find it, maybe we need to go talk to our suppliers and ask them if they can negotiate with us".

So, an IRS agent showed up one day and he said, "Mr. Rankin, by our records it looks like you owe us around \$90,000".

I said, "yes, sir, that is about right".

He asked, "when are you going to get it paid?"

I told him where we were and what we were trying to do and he said, "well, I will give you ten business days to find the money."

And we had probably at that point half a million in receivables which were good as gold because they were large companies and we were doing good work. I found a factor and sold my receivables, got the cash, paid off the IRS and we started growing again. While the factoring was essentially usury rates from an unregulated lender, it allowed us to continue to grow.

The fourth year, we again doubled the size of the business and went from 2 million to 4 million in revenue. We were ranked among the 25 fastest growing privately held companies in the Dallas-Fort Worth area again and among the 100 fastest growing owner-managed businesses in the area. Our revenues approached about 4 million. We remained profitable. We invested in the business that year, putting in new accounting systems and restructuring the business.

In 1999, we were placed on the Inc. 500 list by Inc. Magazine, quite an honor. Our large commercial bank, now merged with another large commercial bank, decided without any warning to discontinue our receivables financing line. My controller called me one day and said "I tried to move money over from our credit line and there is nothing there." I had payroll going out on Saturday.

Fortunately, through all this, we found a way to maneuver our way through it and in early 2000 we were able to borrow \$1 million from an SBIC lender which has given us the leverage now. We are tracking at 10 million in revenue for 2001.

I believe if we had had legislation like this, giving us the ability to defer some taxes, which is money which we had earned already, that we would have either been able to get financing from a conventional lender or we would have been able to use our own capital to fund our own growth.

So I think, unfortunately, I am one of the few lucky people who were able to make it out of "no man's land", but I know there are millions of businesses out there who are not making it and who are

creating lots of jobs, good jobs. So I would urge you to get this legislation moving.

Thank you.

[Mr. Rankin's statement may be found in appendix.]

Mr. TOOMEY. Thank you very much for your testimony, Mr. Rankin.

At this time, I would welcome and recognize the CEO of Tatum CFO Partners, Mr. Douglas Tatum.

Thank you for being with us.

**STATEMENT OF DOUG TATUM, CHIEF EXECUTIVE OFFICER,
TATUM CFO PARTNERS, ATLANTA, GEORGIA**

Mr. TATUM. Mr. Chairman, members of the subcommittees, I would like to start with giving you a little perspective. As CEO of the largest CFO firm in the United States, we have over 300 partners located geographically in 24 offices and we provide CFO assistance and serve as CFOs—

Mr. TOOMEY. Excuse me, Mr. Tatum. Could you bring the microphone a little bit closer to yourself, please?

Mr. TATUM. I apologize. Is that better?

Mr. TOOMEY. Much better.

Mr. TATUM. Our partners serve as CFOs and provide CFO assistance to companies, many companies like you have heard from already this afternoon.

Our experience with these emerging companies led us to publish a small brochure which we have provided to you entitled "No Man's Land: Where Growing Companies Fail". We hope that this will provide you some context with my statement today. We have found that the issue that these two gentlemen have talked about "No Man's Land", strikes a resonant chord with entrepreneurs all across the country.

I would like to limit my comments specifically to the BRIDGE act and summarize those, rather than go through my written testimony, around the two charts before you here today. "No Man's Land", in summary is a stage of growth where a company is "too big to be small and too small to be big". And what you are hearing when the gentlemen talk about the difficulties they have had going through there relate to two very specific issues that we would like to discuss with the committee.

The first one is the microeconomics of growth. This particular illustration is built from an economic model that accounts for the typical asset growth characteristics of a rapidly expanding business on accrual accounting and transitioning through what we refer to as "No Man's Land". What is very important to understand is that, as you can see from the chart, revenue in this case went from \$2.8 million to \$6.4 million over a five-year period. Profitability grew in each one of those years.

What is counter intuitive and what we would like to make sure that the committee members understand is that even though the company is growing, even though the company is profitable, it is cumulatively negative cash flow.

To summarize our intent about the BRIDGE Act is that it would correct an unintended consequence in the tax code that currently has enormous detrimental effects on the economy, and on job

growth in particular, because it asks a taxpayer who is growing and profitable under the accrual method to dispense cash that it does not have.

The second area that I would like to draw your attention to in summary of my written comments is the issue of the “capital funding gap”. We heard a little bit about that in the testimony just before mine. What we discovered is that there is a capital funding gap, we estimate, between about a quarter-million dollars and a million dollars in terms of the availability of capital to emerging growth businesses as contrasted to “small businesses”.

It appears that, as indicated earlier, many businesses are able to accumulate the capital to get a start-up going. They get that from credit cards, from friends and family, from relatives that pledge assets to the bank, and they are thereby able to get the business started.

Those businesses that, for whatever reason, get that combination of items together that all of a sudden cause it to grow enter into a “Capital No Man’s Land”, where the business requirements—the requirements for capital—exceed the personal assets of the individual.

The primary financing in the U.S. economy in the early stages relates to the personal assets of the individual. When the business grows to a certain level, the capital requirements for that business exceed the personal assets of the individual and it falls into a capital funding gap. What we have discovered in interviews with major regulated and non-regulated capital providers, including a detailed review of their internal economic models, is that because these businesses are risky they have to assign account management and collateral management to those businesses in order to make that loan.

What they have determined is that with financing smaller than a million dollars, that the cost of an account manager, with a senior loan officer or a loan officer that execute judgment, and the cost of the collateral management can be upwards of 1400 basis points, or as much as 14 percent before you even add the cost of the money. Therefore, the lenders that you see in this capital base are typically lending money from 25 to 30 percent interest rates, which is self-liquidating to the business.

Until the business gets large enough where the business assets are significant enough to attract the kind of account management and collateral management to oversee the loan and significant enough for that management to be at a low enough cost to provide adequate capital, these two gentlemen faced a funding gap in growing their businesses. The proposal in the BRIDGE Act simply would allow that business to retain the capital for a temporary period that normally would be paid in taxes in the business until it is large enough to obtain external financing.

I know a little bit about Ed Rankin’s business in particular. Once he received the million dollars in SBIC financing, he was able to grow his business to the size where he is now attracting attention in the major capital markets. He could be at 500 employees soon, and he could very well have 500 in five years.

[Mr. Tatum’s statement may be found in appendix.]

Mr. TOOMEY. Thank you very much for that very lucid explanation of the cash flow crunch that growing businesses face.

At this time I would like to welcome and recognize Ms. Karen Kerrigan. Ms. Kerrigan is the chairman of the Small Business Survival Committee.

Thanks for being with us.

STATEMENT OF KAREN KERRIGAN, CHAIR, SMALL BUSINESS SURVIVAL COMMITTEE, WASHINGTON, DC

Ms. KERRIGAN. Thank you, Chairman Toomey and Chairman DeMint, for holding this joint hearing today on this most important issue for America's small business and entrepreneurial sector. Let me also thank the ranking members of the committees, Congressman Pascrell and Congresswoman McDonald, for their interest and concern about this topic before us today and other issues facing small business.

I am pleased to have the opportunity to testify on the issue of capital access and funding solutions for start-up and emerging firms and, more specifically, how the Congress can address this enduring challenge through the Start-Up Success Accounts Act of 2001 and the BRIDGE act proposal. I applaud Representatives Jim DeMint and Brian Baird for their bipartisan perseverance on this issue in introducing the SUSA act again in this Congress as SBSC believes quite strongly that it would make a meaningful difference for many firms across this country.

We are also encouraged by the creativity and the contemplation that has gone into the proposed BRIDGE act, a solution for entrepreneurial, emerging high growth firms which provide the bulk of innovation and job creation in our country.

Access to capital remains an acute obstacle for many small firms, as the full Small Business Committee learned in its hearing on May 17th. The testimony and conclusions of witnesses serves to support the follow-up hearing today on specific ways that Congress can help firms tap the capital they need during start-up and high-growth periods where a capital gap exists.

Accessing adequate capital is not only an issue for the entrepreneur who wishes to take his or her idea to the marketplace, but becomes an even more serious one for small firms that struggle through their tumultuous early years. And if a business takes off and makes it to the high growth stage, these firms, too, are continually burdened by the lack of capital or reasonably priced capital in general because the size of the loans are not economically viable from the lender's standpoint as well as other reasons, as identified by Mr. Tatum.

The practical concept underlying both the SUSA and BRIDGE act will enable small start-up and emerging firms to more steadily manage their finances and, of course, retain capital. The beauty of both proposals are that they enable business owners to be more self-reliant, manage and plan better and more efficiently and, as several members of my organization have stated in responses to these proposals, become self-funding.

The lack of capital for early stage and growth firms combined with the effects of the tax code which discourages capital retention in effect conspire to squeeze many of these enterprises ultimately

leading to many business failures. That is why the proposals before the joint committee today are so worthy of consideration by the Congress.

The SUSA option, H.R. 1923, whereby early stage businesses in their first five years would be allowed to place up to 20 percent of taxable interest into tax-deferred savings accounts opens up new financial planning and financing opportunities for small firms. Most start-ups, even those demonstrating early success and profit, as this legislation is designed to target, will face cash shortfalls at critical phases.

S.U.S.A. is targeted at the right problem, or should I say the right audience: early-stage businesses, firms in their first five years that are very fragile. The numbers speak for themselves, as 80 percent of businesses fail during the first five years.

Even successful firms are going to hit road bumps and pot holes. This is where the safety net of having an alternative source of capital, being able to self-fund through the business owner's own SUSA account, can make a difference.

If a start-up business is given the opportunity to retain more of its capital through a SUSA rather than engage in tax-motivated spending, I believe more businesses will succeed. The BRIDGE act is a complementary proposal to SUSA, tackling the same problem faced by new and growing firms, yet its distinction is apparent in the type of business that it would benefit: the rapidly growing, entrepreneurial firms that create the bulk of new jobs in the U.S.

The impressive success of a start-up to the level of an emerging company indeed is an exciting triumph, yet capital access challenges continue to dodge the company as it becomes more successful. And the health of the U.S. economy and the job growth created by these emerging businesses is dependent upon the ability of the company owners to successfully attract capital.

The BRIDGE act proposal aims to help growth businesses, those growing by 10 percent or more above the prior two years, by retaining their own funds for a temporary period for continued growth. The additional capital provided by the tax deferral would allow the company to survive the capital gap that small growing firms go through in order to thrive as an ongoing business concern.

There is a great need for both SUSA and the BRIDGE act. Both of these initiatives are sound approaches toward equipping firms with self-funding options, allowing small businesses to more independently address their own capital needs.

Thank you again, Chairman Toomey, and we are certainly on board zeroing out capital gains. We think that is a wonderful proposal that gets SBSC's support. We are encouraged and quite pleased that the Congress, and in particular the House Small Business Committee and its subcommittees continue to remain hard at work exploring a range of issues that will create a better environment for entrepreneurship and risk taking.

I look forward to the committee's questions.

[Ms. Kerrigan's statement may be found in appendix.]

Mr. TOOMEY. Thank you, Ms. Kerrigan, and thanks for your advocacy for small business.

At this time, I would welcome and recognize Mr. Bob Morgan, president of the Council of Growing Companies.

Thank you for being with us this afternoon.

**STATEMENT OF BOB MORGAN, PRESIDENT, COUNCIL OF
GROWING COMPANIES, McLEAN, VIRGINIA**

Mr. MORGAN. Thank you, Chairman Toomey, Chairman DeMint, and all the members, one, for your passion and one for your understanding of the issues small and growing companies experience.

The Council of Growing Companies, we have 1200 heads of, CEOs—

Mr. TOOMEY. Excuse me, Mr. Morgan. Could you bring the mike closer to you, please?

Mr. MORGAN. Sure.

Mr. TOOMEY. Thank you.

Mr. MORGAN. Is that better?

The Council of Growing Companies, I interact throughout the United States with 1200 heads of, CEOs of fast growing companies. We are trying to help these folks be successful. As you know, this is most of our job creation in the country.

Our companies range from as small as 3 million in revenue up to a billion. They are all experiencing double-digit revenue and employee growth. They are on a rocket ride. Our focus is to help these CEOs and their companies with information and networking and best practices and sometimes just dealing with loneliness and not always being understood.

We have chapters in major cities. Our overall mission is to help create a social, economic and political environment that actually does nurture and understand entrepreneurship. So let me comment just briefly about the BRIDGE act and why this is of such importance to the country.

Small business has certain needs, as you have heard, as it begins to grow and emerging companies that begin to grow fast get into a little different arena where they have somewhat unique problems.

Small business usually can obtain financing in relatively small amounts like under \$250,000. But when this takeoff occurs, you quickly in a business outgrow any personal asset-based source of financing such as are available to an entrepreneur or their family or friends or credit cards. This rapid growth actually just outstrips the revenue, as you have heard from Ed here. Profitable, growing and yet negative cash flow. Because as you start to grow, you have to invest in infrastructure, employees, equipment, inventories, and very fast, you in effect out drive your headlights.

Access to capital for these companies becomes very limited at this no man's land because once a growing business begins to get more established, yes, then they can qualify for a credit line or a loan of like a million dollars or more. Capital markets start to open up. But prior to that, and getting that track record established, is just a crucial point in the life of a lot of companies.

How does this happen? You know, here you have a growing company, it is profitable, and yet it owes income taxes, it is winning awards, getting a lot of publicity. What happens is that when you are on an accrual accounting basis, which you should be and must be for tax purposes, you start to report a taxable profit and yet

your sales growth outstrips your return on assets. And at that point you have a negative cash flow.

And at that point, a growing company typically will use up all of its internal capital by trying to reinvest in the company's growth. So this BRIDGE act would be a wonderful solution for many companies that today would probably still have survived if this had been available as a resource.

As I have talked to CEOs throughout the country about this idea, they have all reinforced that, wow, I wish we had had that when I needed it.

This is not a tax deduction, it is not a tax credit, it is not a government giveaway. This is simply a deferral with interest paid. It has to be a win-win. And under the draft that has been proposed, there are plenty of safeguards as we have viewed those with the amounts being deposited in trust accounts at banks or other financial intermediaries. The account is used as collateral for a business loan and a deserved loan, because it is backed by money and profit that demonstrate the company's viability.

We urge support of this BRIDGE act and we thank you for your attention in advancing this idea. I welcome your questions.

Thank you.

[Mr. Morgan's statement may be found in appendix.]

Mr. TOOMEY. Thank you, Mr. Morgan.

At this time, the chair will recognize and welcome Mr. Lee W. Mercer, President of the National Association of Small Business Investment Companies.

Welcome.

STATEMENT OF LEE MERCER, PRESIDENT, NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES (NASBIC), WASHINGTON, DC

Mr. MERCER. Thank you, Chairman Toomey and Chairman DeMint and members of the committee. It is an honor to be here today to present our views and my views on what steps Congress might take to increase the availability of capital to small businesses. In one way or another, it is an issue that I have dealt with since 1971 when I started my career representing small businesses as a practicing lawyer in Manchester, New Hampshire. The issue is the critical issue for most small businesses.

The vibrant small business world in America fueled by the independent spirits of individual entrepreneurs is the envy of the world and the foundation of our nation's economic well being. Without it, we would be like most other countries in the world, looking for models to stimulate job and technology growth. Fortunately, we have it.

That said, it is also amazing to consider the number of small businesses that fail each year. SBA estimates that over 260,000 non-farm businesses failed in 1999. Fortunately, more than that by about 5 or 10 percent were started.

It causes us to ask how many might have prospered if they had had ready access to capital in the range of \$250,000 to \$1 million that the committee is considering here today.

Congress has provided programs that address some of these issues. Certainly the SBIC program is one of the better known,

most successful and, in fact, the fastest growing program right now. And SBICs, certainly leveraged SBICs, that have access to government-guaranteed capital invest in increments in the \$250,000 to \$1 million range.

I have provided the committee with the FY 2000 statistics that speak to that point.

However, notwithstanding the program's success, more can be done and done at little cost to the government to increase the effectiveness of the SBIC program.

First, I urge the Small Business Committee, the House Small Business Committee, and the House Appropriations Committee to agree on a mix of SBIC fee increases and appropriations that will make \$3.5 billion in participating security leverage available in FY 2002. That is money that will go to equity-oriented funds that make equity investments.

That will immediately create a likely pool of about \$5.5 billion for small businesses and will lead to more senior debt being available to those companies as well.

When the senior debt is factored in, you could have \$20 billion in additional capital created at a very minimal cost to the government, about \$26.2 million, if the government were to flat fund the program for FY 2002.

Second, I urge the committee to seek an amendment to the Internal Revenue Code for the very limited—and I mean limited purpose of excluding debenture leverage from the type of acquisition debt that under the tax code generates UBTI, unrelated business taxable income, for tax-exempt investors automatically, no matter how carefully the debenture SBICs structure their investments.

U.B.T.I. effectively takes 60 percent of the private capital that is potentially available to debenture SBIC fund managers in fundraising off the table. If Congress were creating a debt-oriented small business program today that relied on private capital as its foundation, I am sure it would not take 60 percent of that capital out of play.

Amending the Internal Revenue Code as proposed will see more SBIC debt capital available to small businesses. This is subordinated debt capital, not bank loans. This is a more risk-oriented debt. This is particularly important because the types of businesses that seek and obtain this type of subordinated debt financing are generally community businesses like restaurants, hardware stores, local manufacturing companies and the like. They may not be the go-go companies that attract major equity infusions, but they are good and steady employers. The amendment we propose will address capital access for these companies at virtually no cost to the government.

Finally, I commend to the committee and to Congress the approach represented by the proposed BRIDGE act and SUSA acts. NASBIC has endorsed the BRIDGE concept and the SUSA concept as in the same category, albeit slightly different in focus and manner of implementation. Both acts declare the government's support for growing small businesses and make it clear that the government will not permit technicalities of law or accounting principles to punish someone for success, especially in the early fragile years of a growing business.

Whether structured as an income deferral or a low cost loan for a calculated tax liability, both concepts are self-executing, require no government bureaucracy to administer and represent the best of selection efficiency.

No entrepreneur could ask for more and neither could the country that benefits from the collective efforts of all America's entrepreneurs.

Thank you, Mr. Chairman, and I look forward to your questions. [Mr. Mercer's statement may be found in appendix.]

Mr. TOOMEY. Thank you, Mr. Mercer.

And let me thank all the witnesses for their testimony this afternoon. Thank you very much. It was very informative.

I will recognize myself for five minutes of questioning and we will try to stick to the five-minute rule so that we can give everybody a chance to ask their questions and then if there is interest to do so we can do a second round of questioning.

First, Mr. Brinson, first of all, thank you for coming, thank you for your testimony. In your written testimony, you advocate a provision in the tax code that would permit the deferral of federal income tax such as is contemplated by these bills.

In your experience, as you grew your business, can you share with us how that would have facilitated or accelerated the growth of your business and looking forward, if you have an interest in further expansion of your business, can you see how this would specifically help your business to grow?

Mr. BRINSON. Yes. As I pointed out in my written testimony, we did pay considerable income tax in 1999, the year that we were trying to get this new business, this new club, together. If we had been able to defer that, that would have helped a great deal, I think, to help us get the new club started. So I like the idea a lot and I think it could benefit a lot of businesses.

Mr. TOOMEY. Thank you.

Mr. Rankin, your business is in the service sector of our economy and, like many service businesses, my assumption is that most of your assets are the intellectual capacity of your employees, more so than hard assets of plant and equipment.

Mr. RANKIN. Correct.

Mr. TOOMEY. In that capacity, of someone in the service sector, do you think it is particularly difficult for service companies to acquire capital? Is that an additional burden that you face that perhaps others with greater sources of collateral might not face and could you share with us a perspective of how the service sector might benefit from this legislation?

Mr. RANKIN. It has been a subject of conversation I have had with some of the bankers that I am familiar with and know. There seems to be no recognition in the traditional financing circles of the transformation of our economy from a brick and mortar economy to a service business where assets of businesses like mine really reside in the brains of the people who work for me and the receivables that they generate.

There are very few good sources of financing for that. If I were a hard asset business with inventory, buildings, plant and equipment, it would be much easier to secure traditional financing, but I really see this as even a more serious problem for our economy

as we go forward because we are increasingly becoming more and more service oriented and our population is becoming better educated and the work that we do here is becoming more sophisticated, more technologically driven. So, yes, I think we do face different challenges.

Mr. TOOMEY. Thank you.

Mr. Tatum, in your testimony, you talked about the cost that an account officer or bank incurs in simply managing the account and if a transaction is not large enough to justify the cost, then presumably there is an incentive not to provide the transaction.

Is that an argument for increased fees? Is that an argument for banks to find another way to be compensated for that? Are there small businesses that would happily pay larger fees if they could get this access to capital? What perspective do you have on those issues?

Mr. TATUM. I think that the banks recognize that as they—and I say banks and non-regulated lenders, because we interviewed both—want to loan capital in that sector. When they project the cost of the account management and the collateral management, they run into a cost problem that means that for them to make money it becomes a significant interest expense to the business, which we refer to as self-liquidating.

I do not think there is an incentive for them to lend money to a business where their cost of capital now exceeds their return on capital. What you are basically doing at that point in time is lending money to a business at a rate that is self-liquidating. They have negative EVA, “Economic Value Added”, if you will. Most of these large lenders are not very enthusiastic about charging a business what they believe maybe usurious interest rates to the detriment of the business, even if they could make money on it. It is a structural capital funding problem related to risk management.

Mr. TOOMEY. Thank you. I would like to follow up that question with a question about whether some kind of equity participation would not be a way to ameliorate that, but I am going to run out of time, so I will do that on my second round and I will now recognize Chairman DeMint for his questions.

Mr. DEMINT. After all the work with some of you and the testimony today, one has to ask who could possibly oppose this idea, but everything here has opposition and nothing seems to be easy. I am sure as you have talked about this idea, you have probably gotten a few folks who have played devil’s advocate with you and said this will not work because of this or that.

I, frankly, have a hard time finding problems with it. While some would say there may be some cost to the government, the worst case is there is some deferral of taxes. In reality, the increased employment and growth of companies are likely to make this a revenue windfall for the government.

Have any of you, and I will just open it to all of you, as we look at both the start-up idea as well as the BRIDGE act, what could we anticipate as far as objections or what type of objections do we need to be prepared to handle with these ideas?

Yes? Mr. Morgan?

Mr. MORGAN. Some folks have commented, including the Associated Press, who are doing a story on this hearing, what if a com-

pany goes bankrupt or defaults and cannot pay the loan, therefore the assets that are tied up securing that loan, you know, who is holding the bag, does that end up as a cost to the government?

And my comment to that is, yes, there is a risk. There is a risk to almost everything that we are doing, our business community is doing, but when you compare the risk of this plan to a lot of other sources, the risk to me seems much smaller. But as an early warning system, I think that is a criticism or a concern or an issue that might be tossed at the BRIDGE act, for instance.

Mr. DEMINT. Mr. Tatum, can you answer that for us?

Mr. TATUM. I would like to add to that. The definition of bankruptcy is that your liabilities exceed your assets, which means you no longer have any retained income in the business. Our tax code allows us to go backwards and to write-off the losses incurred and also to deduct the losses against taxes going forward. So that by the time a business becomes bankrupt, it annually does not owe any taxes.

I think if you would go to Treasury and look at the number of firms when they file their tax returns, when they are bankrupt, I would suggest to you that a very limited number of them actually owe any taxes. In fact, those firms may actually have an asset called an NOL, "Net Operating Loss", that certain businesses try to obtain.

So there is a very specific technical answer to that, and we believe that there is very little risk that the government would incur any cost related to that. I agree with my colleague.

Mr. DEMINT. That it would not have lost anyway, right?

Mr. TATUM. Right. If you had taxable income and you incur a tax and then you end up losing money over time, the amount of tax you owe goes down and by the time you are bankrupt, there are no taxes due.

Mr. DEMINT. Mr. Mercer, did you have a comment?

Mr. MERCER. I would concur. The beauty of the legislation, the way it has been drafted in both cases, is that by definition it does not do you any good unless you are successful, so that reduces the risk substantially. Also, I agree with what Mr. Tatum has just said.

I think inertia is always the single greatest hurdle in government. When I think about what the accrual method of accounting does to small businesses in this area, is not this akin to the marriage penalty for small businesses? And everybody would agree that, gee, we ought to get rid of the marriage penalty, but it does not seem that that happens very easily, probably more because of inertia more than anything else, not because people would argue with the principle. That may well be the case here as well.

Mr. DEMINT. Good.

Yes, Mr. Brinson?

Mr. BRINSON. I think to look at a potential loss is just negative, and I think a great deal more tax revenue will be generated by helping businesses to grow. One of my mottoes is that you are either growing, or you are dying, and small business needs to grow just to survive. And it would produce more revenues, not less.

Mr. DEMINT. Thank you.

I yield back.

Mr. TOOMEY. Thank you, Mr. DeMint.

I recognize Mr. Pascrell.

Mr. PASCRELL. Thank you, Mr. Chairman.

Mr. Rankin, I was curious. The difficulty you had with your bank, did you go to an SBA office before that?

Mr. RANKIN. No, I did not. Actually, I consulted an SBA lending specialist in Dallas who told me that the probability of an SBA loan was probably 50/50 for me and it was going to take too long, so we were going in that direction, but I did not have time.

Mr. PASCRELL. The experience that we have indicates that that office, that local office, can be a tremendous help. There are many banks, of course, that participate in the program. We know that. But many times the people are trained in the SBA office to reach out beyond the banks that we ordinarily reach out to. I find them to be very, very, very helpful.

I was anxious to find out whether you went through that bank because that is what we spend taxpayers' money for, to establish these offices so that they will be of help to people like yourself who deserve it. I mean, that is what your taxes pay for.

Mr. RANKIN. We were looking at it, but we were moving so quickly and our cash needs were so urgent that based on what I learned about it and, with the very limited time, I had to focus my time where I felt that we had the highest probability of a faster success.

Mr. PASCRELL. Okay.

Mr. Mercer, over the last several years, Congress has passed a variety of different laws designed to spur investment in minority-owned businesses and businesses located in low income areas. I am talking about some risk here, which is quite obvious. Some of them have worked, some of them have not, like everything else.

What types of policy should we be looking at, should Congress be considering, to spur investment in low income and minority-owned businesses, in your opinion?

Mr. MERCER. Well, one of the interesting things about the proposal on UBTI is that it would be a boon to the remaining existing specialized SBICs, which, of course, by law, can only invest in minority enterprise. They are debenture SBICs and because of UBTI, they, like everybody else in the debenture program, have a great deal of difficulty raising private capital from tax-exempt investors. And I suspect that they, and perhaps even more than regular debenture SBICs, would benefit from that change in the tax law.

The new markets venture capital program, of course, is aimed in that direction and is just getting off the ground. It is perhaps too soon to know whether that will be as effective as Congress hopes it will be.

I do note that the SBIC program, interestingly enough, in FY 2000 invested in low income areas: 14 percent of all dollars were invested in low income areas and if you increase that to moderate income, so low and moderate income, it jumps to 25 percent. So the interesting thing is I think that the market in a sense is working.

S.B.I.C.s will invest in good businesses wherever they are located, but they sometimes have difficulty finding them. I think one of the single greatest things that SBA could do is to examine and explore why small businesses located in these areas that may have good business plans have difficulty getting those business plans on the desk of a financing source, an SBIC, for example, that can con-

sider them. Deal flow is what an SBIC or other financing source lives by, is the quality of its deal flow. So to the extent that SBA could tackle that issue, and it is a hard one, it would be important.

Mr. PASCRELL. As a follow-up, do you think that the banks are going to embrace this idea, the BRIDGE idea, the BRIDGE accounts? In your opinion?

Mr. MERCER. Would the banks embrace it? In other words, the money placed into the banks? The banks will embrace it if they have first security interest on it. Unfortunately, the banks are not in the business to take a huge amount of risk. If the account is going to be there and serve as collateral for a bank loan, my view is the bank is going to want first position versus the IRS.

The biggest problem I see there. A combination of these two may be the best way to go because when you are deferring income, maybe it works in a different way. Either one of them can work, but, as you correctly point out, the big problem with that account is who is going to claim first whack at it.

Mr. PASCRELL. Can I just ask one quick final question?

What do you—anybody for this one—what do you think about the idea of—I know Mr. Greenspan does not think highly of it, but what do you think about it—of business accounts accruing interest?

What do you think about that? They cannot right now under the law. Checking accounts. What do you think about that? Support it? Good idea? Bad idea?

I mean, we have been under this system since 1930, I think. What do you think of that idea?

Mr. BRINSON. Why not?

Yes. I would say why not?

Ms. KERRIGAN. Yes.

Mr. PASCRELL. Thank you, Mr. Chairman.

Mr. TOOMEY. I thank you the gentleman from New Jersey.

I would point out I had a bill earlier this year to repeal the ban and we have been successful thus far with this. We have the other body that we have to get some cooperation from.

At this time, I recognize for five minutes the gentleman from Washington.

Mr. BAIRD. I thank the chair and I thank the witnesses. I was particularly impressed with the business owners who have—I cannot imagine how frustrating it must have been to you to have a demonstrated, successful model, to have the potential to further grow, to employ more people, to go to the bank only to be told we cannot help you gather the capital. I could not imagine a more clear testimony to the merits of the bill that Congressman DeMint has led the way on and I appreciate that.

Let me ask you how the BRIDGE act—it seems there are two problems. You have the issue of the negative cash flow situation and you have the issue of the banks themselves not wanting to allocate the human resources to process the difficult loans and the point that Mr. Tatum raised about the costs.

How will this BRIDGE act affect that second issue of the banks wanting to allocate the human resources to process it? Could you walk us through that part from your understanding?

Mr. TATUM. One of the ways that we used to obtain capital through a bank was to have the entrepreneur place some collateral

from friends or family, in a bank and borrow it back for the following reason. It created a risk-free loan, and it also created a relationship earlier than would normally be the case because of this situation.

If you talked, as I did, to a senior executive of a community bank holding company, he said just about all the loans that they do in this capital gap they do because the entrepreneur received collateral outside of the business to take the risk out of it, removing the need for loan judgment, and thereby removing the need for account collateral management costs.

By creating an account with these deferred tax funds that can then be borrowed against, you create a banking relationship sooner than normally would be established. Our experience has been that as the bankers have more experience with that company, they tend to expand those lending relationships quicker.

We believe that banks will compete for the BRIDGE accounts. When that happens, what you will end up having is lending institutions who want to lend to these businesses—by the way, they just do not know how to handle them cost effectively—banks will compete by saying if you bring your BRIDGE Act to my institution we will also make an equipment loan on top of the loan for your working capital.

The other thing I would suggest—back to the issue of whose position is first and second—the tax code recognizes philosophically these types of issues. For example, when a business is asked to go from a cash basis to accrual, it creates an immediate tax burden. That tax liability is owed by that business and it does not affect the loans that are associated with that business.

So all we are saying philosophically is that the tax amounts due be deferred placed into an account, and allow that business to borrow it back. The IRS does not have a first lien, if you will, on the business assets when the business owes taxes when it allows the business to pay that off over time when going from cash basis to accrual accounting.

Mr. BRINSON. There is another problem that faces us, too, and I have included it in my written testimony, and that is that there seems to be some requirement that when bank loans are secured by mortgage liens that there be a repayment of principal, and this is ridiculous.

I have a friend in England who owns a whole bunch of small businesses and they have no such thing as this mortgage loan idea where you pay down principal every month.

I think it is rooted in the fact that small businesses in this country originally were in homes, located in homes, and when the small business owner died the business died. So the idea was “let’s get the mortgage paid down”.

A business that wants to expand, as I do, does not want to pay a quarter of a million dollars a year in principal repayments. If there is some way that your committee could look into the banking rules that require mortgage amortization, it would be a great relief.

I had a \$5 million mortgage two and a half years ago and now it is down close to \$4 million. What happened to that money? It went to the bank and they had to send their loan officers out scurrying around looking for new people to lend the money to when

they already have a good customer paying them interest. They already have all the papers, the guarantees and everything else. So this just does not make any sense at all. It would be a great help to many, many small businesses if we were not faced with this requirement.

And our assets do not actually depreciate. If we keep our buildings in good repair, the asset is not depreciating, so that it really makes no sense to require principal payments, mortgage amortization.

Thanks.

Mr. RANKIN. Can I make one quick comment?

Mr. BAIRD. Sure.

Mr. RANKIN. Three years ago, a quarter of a million dollars in the bank account would have been like \$5 million today. And when we received a \$1 million sub-debt loan from an SBIC lender, we had lots of banks interested in talking with us. Just that little bit of quasi-equity, I refer to it as, really made a world of difference for us in terms of how we could operate our business.

Mr. BAIRD. Mr. Chairman, if I might add, I think that is precisely the notion of the SUSA premise that Mr. DeMint and I introduced last year. The SUSA allows you to defer the tax on your profits, you can set that aside in the tax deferred account and that then provides precisely that kind of seed capital that, as Mr. Tatum described, would provide further incentive for the banks to move you into a BRIDGE type account. I think it is very synergistic and that is the benefit of the two bills.

Mr. TOOMEY. The gentle lady from California, Ms. Napolitano.

Ms. NAPOLITANO. Thank you, Mr. Chair.

To Mr. Morgan, Ms. Kerrigan and Mr. Mercer, one of the things that I have heard, especially from the small business community in my area, women-owned business and minority-owned businesses, that they have a hard time being able to get assistance, bank loans, even SBA sometimes because because because.

What have you found in minority-owned and women-owned business? Is that an issue in being able—would you address it, please?

Ms. Kerrigan?

All three of you. Any of the three of you.

Ms. KERRIGAN. You mean just the general access to capital issue? Absolutely. For start-up firms, it is a huge problem, whether you are a minority-owned business or any type of business owner in the start-up phase. Generally, what happens when you do start a business, the start-up capital is generally the easiest type of capital to get and sometimes it is the most costly because the use of credit cards and, of course, you go to your family and your friends and associates and things like that. But it is this start-up period where the banks need a demonstrated track record of success, they view the business or the enterprise as being too risky to provide the type of loan and type of capital that is needed.

Ms. NAPOLITANO. Do you see this particular bill being of assistance to those entities?

Ms. KERRIGAN. Well, I do. If those entities show some signs of success and they are profitable, they can put aside this money to be used in the second, third, fourth year, whenever that need develops to have this cash on hand. You have to—with the 600,000

to 800,000 businesses that are started each year, many of them minority and women-owned businesses, women are starting businesses at three times the rate of men, there has to be an assumption that some of those businesses are successful and very successful. But even the most successful firms are going to run into some cash problems, maybe not the first year, but maybe the second or the third year they may want to expand. And I am speaking mostly to the SUSA account right now. This is designed for those types of businesses and I think it makes practical sense.

I have talked to a lot of my start-up members about this and they think it is a wonderful idea. They can become self-funding and self-reliant and they do not have to depend on the banks or any other outside resources.

Ms. NAPOLITANO. Gentlemen?

Mr. MORGAN. I am delighted with your question and your sensitivity to these areas. It has been a problem—

Ms. NAPOLITANO. Do I look like one?

Mr. MORGAN [continuing]. That is getting better, but one specific way that the BRIDGE act would help here, banks can even hide behind their obligation, their fiduciary responsibilities to protect the deposits of their depositors. You know. And risk is always a reason for a bank to decline.

The BRIDGE act, for instance, gets at two key elements to reduce that risk. One, it reduces the cost to the bank of papering, of processing, analyzing, all of that. And, second, it reduces the risk factor itself because the money that is being used for a loan to keep growing the business is money that has already resulted from a profitable, well managed institution that is showing a lot of promise.

Mr. MERCER. I think one of the things we have to remember is for the types of businesses that you are mentioning their, their capital needs may well be and probably are under the \$250,000 threshold that is specifically mentioned with regard to this hearing. A lot of the businesses are self-employment, so it is probably not even recognized as a non-farm business by statistics.

I think what is appealing and may be—I am not an expert on the provisions of the SUSA act, but it seems to me that the SUSA Act would be particularly applicable there. Most of these businesses are probably started on a cash basis, not an accrual basis, of accounting, and literally run out of shoeboxes, cash in, cash out. I think as I read the SUSA act, it would basically allow them in a successful year to defer recognition of that income and essentially average income over a bumpy two or three-year period while they are getting started. Then maybe they branch off and make use—they may grow enough to go into accrual method of accounting, which they definitely will have to switch to if they are going to be a successful growing company and attract outside capital sources. Then maybe the BRIDGE Act takes them from there up to the next level. So I do think it would be of help.

Ms. NAPOLITANO. Well, one of the reasons, if I may just comment on that, there was a young man who started a small—it was a start-up and did so well that he wanted to expand and he was having problems getting some assistance in funding, so rather than do that, he and his partner sold it for \$2.1 million. I mean, that is not

a small entity to start off and they did it at home and did beautifully well, but there were problems for him and he decided it would not be worth his while to spin his wheels trying to find the funding, the financing.

So there are all kinds of cases. So to me, we need to be able to help those new entrepreneurs be able to become more successful. It does mean jobs in our areas.

Mr. TATUM. Just one quick comment. I think the Kauffman Foundation research indicated that of the G-7, that the participation by women in start-up and emerging growth businesses exceeded all the other G-7 countries combined. So specifically, these two proposals will uniquely impact an emerging trend, which is women growing businesses.

Ms. NAPOLITANO. Right. And they work twice as hard because to them it is their life support, in many instances, their whole support.

Ms. KERRIGAN. And I would just like to echo that. Last year about this time, I was at the National Women's Small Business Summit in Kansas City and the access to capital—these were successful women business owners, some of them in their tenth year, many of them in their start-up years, who said this was a serious problem and echoed this concern. And they talked about tax credits or any type of tax deferrals. They were talking conceptually about the things that we are talking about here today that can help them survive and grow and become viable entities.

Mr. TOOMEY. Thank you. Thank you.

Let me congratulate and thank Mr. DeMint and Mr. Baird for the creative and constructive ideas that they have developed which could really, I think, from what we have heard today go a long way to alleviating a very real challenge, but most of all let me thank the witnesses.

All of you have provided some very informative, very useful information and let me assure you your testimony will help us to develop the support that this legislation will need to move in this Congress.

The hearing is adjourned.

[Whereupon, at 4:00 p.m., the subcommittees were adjourned.]

Representative Jim DeMint
OPENING STATEMENT
Joint Subcommittee Hearing:
(Workforce, Empowerment, & Government Programs
AND Tax Finance & Exports)
Access To Capital Solutions
June 26, 2001

Chairman Toomey, I appreciate the opportunity to join with you in bringing these two subcommittees together today to examine more closely some of the issues and questions raised at the full committee hearing on access to capital earlier this year.

Inc. Magazine commented in its annual State of Small Business Issue this year that, "If small business were a boxer, the blows of the past 12 months might have left it on the ropes." That same issue cited financing as the second largest reason for small business bankruptcy.

The overall problem of access to capital and capital retention is what we are focused on today; however, those challenges manifest themselves differently for Start-Ups and Emerging Growth Businesses. From a public policy standpoint, I am pleased that we have this opportunity to examine the different financing needs of these two types of businesses and explore legislative solutions.

New businesses have the potential to create hope and opportunity for many Americans. They are an integral part of the renewal process that defines market economies. New and small firms play a crucial role in experimentation and innovation, which leads to technological change and productivity growth.

They also provide an essential path for many to enter the economic and social mainstream of society. Small business is the vehicle by which millions access the American Dream by creating opportunities for women, minorities, and immigrants. In fact, minority- and women-owned businesses make up two of the fastest growing segments of new small businesses.

While this is encouraging, a large number of these new businesses fail in the first few years, often for lack of capital. A primary cause of this is that our tax code does much to discourage capital retention. The ultimate result is less staying power. Operating with no capital, even in a small downturn in sales can often put a new company out of business.

Earlier this year, Representative Baird and I introduced H.R. 1923, the Start-Up Success Accounts (SUSA) Act of 2001. The purpose of this legislation is to give new small businesses an additional tool to manage finances and retain capital. H.R. 1923 would allow a start-up to place up to \$100,000 of taxable income into a SUSA Account over the course of the first five years of business operation. This would allow new small businesses that are profitable in one year to set aside some profits to prepare for a down-turn in later years. This bill is similar to a bill by our colleague, Kenny Hulshof, which would help farmers and ranchers manage capital with FARRM Accounts.

Fewer people may be familiar with Emerging Growth Businesses and their crucial value to the U.S. economy. Emerging growth businesses are a precious national asset; they are America's job generator, providing over ninety percent of the net new employment in the last ten years. Evidence also indicates that they are the only firms that provide new jobs during suppressed economies, like the present one.

Emerging growth businesses confront a unique threat in the area of obtaining and retaining capital and ironically are most vulnerable to failure in the period while they are quickly expanding. Although seemingly counter-intuitive, when these firms enter a high-growth phase and are experiencing increased profits under accrual accounting standards, they often face a transitional cash flow shortage, or negative cash flow, due to the need for increasing investment in working assets and new personnel as sales expand. The tax code compounds the difficulty in retaining critical capital during the high-growth phase because it forces an expanding business to pay taxes on accrued income during this period of cash shortfall.

Because these firms are not big enough to attract outside asset-based financing they fall into a “capital funding gap.” The result is that emerging growth firms may not generate sufficient cash flow even as they enter their profitable years to cover income tax liability. This capital funding gap has a measurable and detrimental impact on the U.S. economy.

To help resolve this capital funding problem for Emerging Growth Businesses, Congressman Baird and I have been working closely with Doug Tatum on the “Business Retained Income During Growth and Expansion”(BRIDGE) Act, which we hope to introduce soon. In order to provide emerging growth firms with needed cash flow as they expand sales revenue, the BRIDGE Act would allow a firm that meets the growth test to temporarily defer a portion of its Federal income tax liability. The deferral would be limited to \$250,000 of tax, which would be repaid with interest. The tax-deferred amount would be deposited into a separate BRIDGE Account at a bank and the firm could use the account as collateral for a business loan from the bank.

This proposal could bring tremendous National benefits as a way to catalyze the most significant job-creating sector of the economy. We anticipate that BRIDGE would have only a modest revenue effect initially, which would become neutral over a longer period. It is essential that we in Congress address what finance experts know: the tax code jeopardizes small, rapidly expanding businesses in their most fragile and important moment of development. Increasing access to capital, bringing fairness to the code, and surging the economy forward is what we want to do with this legislation.

As one who owned a small business before coming to the House, I am aware of the devastating effect that capital shortage can have on business operations and survivability. I am pleased to have the opportunity to work with Members of the Committee on both sides of the aisle and finance experts to remove obstacles that will allow small businesses to not only survive, but thrive. It is not easy start or grow a business, especially with our current tax code, and I believe that anyone who takes on this challenge deserves our respect and support.

Finally, I would like to thank all the witnesses who have come to testify here today: Mr. John Brinson, President of Lehigh Valley Racquet & Fitness Centers; Mr. Ed Rankin, Founder and CEO of People Solutions Inc.; Mr. Doug Tatum, CEO of Tatum CFO; Ms. Karen Kerrigan, Chair of the Small Business Survival Committee; Mr. Bob Morgan, President of the Council of Growing Companies; and Mr. Lee Mercer, President of the National Association of Small Business Investment Companies (NASBIC).

**Opening Statement
Of
Rep. Juanita Millender-McDonald**

Good Afternoon Mr. Chairman.

Today's hearing focus on the lack of access to capital by small business is very timely.

Recent studies have documented that the greatest growth in employment has resulted from small businesses with less than 100 employees. Although small or emerging businesses are vital contributors to our economy, current banking and lending policies fail to provide them with

the financial resources necessary to sustain their growth, in order to weather the challenges posed by economic expansion and contraction. Furthermore, the reality of economic growth and decline can wreak havoc on small and emerging businesses, especially minority and female-owned enterprises. And there are a number of factors that undermine the ability of emerging businesses to be competitive and successful.

One vital factor relates to the strict requirements that lending institutions set-up as they assess the risk portfolios of prospective clients. Emerging businesses

in my district of Watts, Compton and Long Beach are disillusioned about the prospect of applying for loans. They *frustrated* ~~understand~~ that their loan applications will be rejected, because they do not have the track record or assets necessary to fulfill strict lending criteria by financial institutions.

My colleagues, Reps. DeMint and Baird have introduced practical legislation that is tied to our tax code that will provide incentives and a mechanism for these businesses to deposit a maximum of \$100,000 into an account that can be used in the five-year start-up

period which is very crucial to emerging and small businesses. This practical legislation will minimize the likelihood that they will have to engage in debt financing, and provide them with funds they can access during times of need.

Another factor that undermines the potential of emerging businesses to grow pertains to SBA loan programs that have been revamped. It is crucial that programs such as Microloan and 7(a) continue to exist in a practical form that is not tied to user fees. The current administration, if left to its own devices, would eliminate all direct funding for the

SBIC program and require funding through fees levied on the users of the programs. This would be an impediment, not an aid to emerging businesses interested in obtaining capital.

Finally, I believe that it is very important that small businesses be relieved of the restriction relating to receiving interest on their business accounts. Interest derived from those funds would enable them to make money and generate additional capital.

Mr. Chairman, there are a myriad of factors related to access to capital that undermine the potential of emerging

businesses to grow. I am pleased to participate in this hearing as we explore policies and procedures that require immediate changes. We must breathe new life and vitality into small and emerging businesses, and the method to achieve this is through providing access to capital. Thank you.

Remarks of Subcommittee Chairman Patrick J. Toomey

“Proposed Solutions for the Capital Funding Needs of Start-Up and Emerging Growth Businesses”

June 26, 2001

This afternoon, the Small Business Subcommittee on Tax, Finance, and Exports convenes in a joint hearing with the Subcommittee on Workforce, Empowerment, and Government Programs to address an important challenge facing small businesses throughout the nation – access to capital. This hearing follows the full committee hearing conducted on May 17, 2001, which focused on results from a Federal Reserve U.S. Bank Survey, which supported evidence of tighter loan standards for businesses attempting to obtain commercial and industrial capital.

Capital is the lifeblood of small businesses. For a citizen with the dream of becoming an entrepreneur, a small business owner looking to more efficiently bring goods and services to the marketplace, or a small or mid-sized business attempting to maintain profitability, access to capital is imperative for growth, and in many cases, survival.

According to a GAO report issued last year, the Office of Advocacy estimated that the total unmet need for early stage equity financing for small businesses runs about \$60 billion annually. The largest unmet need for small business equity financing is typically between \$250,000 and \$1 million.

There are a number of potential solutions to the shortage of capital. I want to especially recognize my colleague, Jim DeMint, for his work in crafting the BRIDGES Act and the SUSAs Act.

The Start-Up Success Accounts (SUSA) Act of 2001 would allow small businesses with gross receipts of up to \$2 million to deduct and place up to 20 percent of taxable income into a SUSA account for each of the first five years of business operation. If enacted, this legislation

would allow small businesses to draw down on the funds from the SUSA account over a five year period from the time of deposit, stabilizing the flow of capital and equipping the start-ups to save for the future.

The BRIDGE Act would allow a firm that has experienced a sales growth of 10 percent or more above the average gross receipts for the prior two taxable years to temporarily defer a portion of its Federal income tax liability. The deferral would be limited to \$250,000 of tax, which would be repaid with interest over a four year period.

Chairman DeMint clearly understands the challenges facing small businesses. His creative approach to addressing this challenge has presented us with a viable option which, if enacted, will reduce the tax burden on both new and emerging growth small businesses.

However, I believe the most effective way to resolve this problem is to provide capital gains relief to firms who are willing to take the risks associated with capital investment. While capital gains relief would benefit the national economy, I believe the only way to provide a long term stimulus is to eliminate the capital gains tax altogether. The capital

gains tax simply serves as a government imposed obstacle to both individual and business savings, investments, and economic growth. That being said, it is also important to recognize that capital gains relief and Chairman DeMint's proposals are not mutually exclusive solutions .

Small businesses have been the cornerstone for the nation's economy for decades. As they continue to succeed and grow stronger, effective use of new capital formation strategies is essential. Over the past ten years, small and mid-sized businesses have stimulated growth and created opportunities for America's workforce. It is imperative we work to resolve their existing problems with capital finance to ensure this prosperity continues.

I look forward to the testimony of the witnesses before us today. I want to particularly thank those who have traveled a long distance to be with us, including Mr. John Brinson, a small business owner in my District who has experienced first hand the challenges associated with the lack of available capital. I now yield to my good friend from South Carolina, Jim DeMint.

TESTIMONY

Committee on Small Business

Tuesday, June 26th, 2001

John F. Brinson, President, CEO, Majority Owner

Lehigh Valley Racquet & Fitness Centers

- with clubs in Allentown, Bethlehem, South Whitehall, Trexlertown, PA

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Good afternoon. Thank you for the opportunity to testify. Small business is the heart of America, the driving force and the job creator behind the great economic enterprise that is the USA.

I have been employed by small businesses continuously since 1946 when I was 10-years-old, except for my Army service, 1954 - 1962. During all this time, I have had good relationships with banks. However, more stringent bank regulations have made it increasingly more difficult to obtain capital for small business expansion.

In 1999, my business sought capital from our bank, First Union, to expand, and to add another fitness center to our 3-club chain of large successful clubs. For 1999, our clubs paid over \$69,000 in Federal Income Taxes, not a fortune, but enough to impede growth opportunities.

We asked our bank to lend us \$500,000 to help finance leasehold improvements for our new club, agreeing to pledge the club's assets, and to personally guarantee the loan. We agreed to put up \$300,000 ourselves.

First Union is an excellent bank, and we have enjoyed a fine relationship with them and their predecessors for 20-plus years. However, they refused our request because "their portfolio did not want any fitness club loans beyond what they already had." At the time, we had a \$5 million mortgage loan which had never been in default (and, never has been). The loan was fully secured by the assets of the 3 clubs, totaling over \$8 million, and by the personal guarantees of the stockholders and partners, including myself.

I told them that we would borrow from another bank. They pointed out that we could not do so without their permission, because of loan covenants, and permission was denied. Thus my partners and I were prevented from expanding our business.

But, we really wanted and needed another club in the growing west end of the Lehigh Valley. So, I had to put together a separate ownership group to own the new club. That group had to put up all the capital, without any bank loans, a total of over \$1,000,000. I do not own any part of the new club. (We operate it under a management contract with the new ownership group.)

The new club, Trexlertown Fitness Club, LLC, opened in August 2000. It is hugely successful already and has greatly helped our other clubs, as well, especially because our Memberships include all our locations.

However, the down-side is that our financing costs are higher than they would be if we had a bank loan. Unfortunately, banks are not - for the most part - interested in small business, because that involves risk. Banks prefer no risk.

On a related subject, the typical small business mortgage loan requires principal amortization. This is ridiculous for a business which is trying to expand. (The policy is rooted in the past, when most small businesses were operated out of the home, and the business died when the owner died.)

We don't want to pay down debt while trying to expand. And yet, we are forced to pay down our debt by over \$250,000 per year. The bank must then find someone to lend that money to, which is ridiculous, when they already have a good customer paying them interest on that money.

In summary, I would like to see (1) a relaxation in the government regulations which make banks too conservative and reluctant to lend to small business, and (2) some provision for deferment of Federal Income Taxes (corporate and individual) when the money is invested in small business expansion.

Alternatively, why not just do away with the enormously unfair, complex, and horrendously expensive Internal Revenue Code (we paid our accountants over \$40,000 last year - most of it to cope with Federal Taxes), and replace it with a simple, fair, and inexpensive flat tax - on sales to final users? In other words, a true sales tax (not a V.A.T.!) levied on businesses, which they would, of course, pass on to the consumer.

Why not? Consumers pay all taxes anyway!

Thank you.

End of Testimony

Resumé attached

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Statement of
Ed Rankin, Founder and Chief Executive Officer
PeopleSolutions, Inc.
Before the
Subcommittees on Tax, Finance, and Exports
and on
Workforce, Empowerment, and Government Programs
of the
House Committee on Small Business
On June 26, 2001

**“Proposed Solutions for the Capital Funding Needs of Start-Up
and Emerging Growth Businesses”**

Introduction

Good afternoon Chairman Toomey and Chairman DeMint and Members of the Subcommittees. My name is Ed Rankin. I am the Founder and Chief Executive Officer of PeopleSolutions, Inc. We are a Dallas, Texas-based company, with additional offices in Austin and Houston, Texas. We were an early entrant into a new, disruptive industry-- now referred to as human resource management outsourcing. The industry, estimated by some to be as large as \$60 billion in two years, is transforming how U.S. industry attracts, retains, and develops people.

My testimony will focus on our experience of starting and growing a new business, and the challenges we faced in financing the expansion of this new company.

Starting a new company

I capitalized PeopleSolutions with a \$1,000 deposit into a commercial checking account with a large bank on February 14, 1994. We began operating in an executive suite office with two employees, one notebook computer, an inkjet printer, and some used furniture. In our first year, we billed almost \$400,000 in revenue and earned 10% net income. We financed the business with personal savings. My personal income for that year barely exceeded my annual home mortgage payment.

In 1995, our second year of operation, our concept started to gain acceptance from the market, and we began to grow. We hired several people, and moved into a small office of our own. In that year, our revenue exceeded \$1 million. We again earned around 10% net income. I doubled my personal income to almost one-fourth of what it was before I started the company. I spoke with our bank about a business loan. It was difficult to get them to even return my calls. We were a young service business with few

tangible assets with which to secure a loan. I was told "no." Cash was tight, but we squeezed by.

A growing company, but out of cash

In the third year of operation, we really began to grow. Our workforce of well-educated, professionals expanded dramatically. Our clients, predominately, large U.S.-based multinational corporations were asking us for more and more services. We were growing very, very fast. We bought computers, a phone system, and a copier. Revenue for 1996 exceeded \$2 million. We were profitable. We were ranked among the 25 fastest growing privately-held companies in the Dallas-Ft. Worth area. And we had no cash. Some of our clients paid in 30 days, some in 45 days, and some in 60 days. Our employees expected to get paid every two weeks. We were having difficulty making payroll.

I was literally driving to clients to pick up checks from their accounts payable departments and rushing to our bank to make the deposit so our payroll checks would clear. An IRS agent paid a visit to discuss my plan to pay our delinquent income taxes. I consulted an independent SBA lending specialist. The probability of obtaining an SBA loan was about 50%, he said, but it would take some time. The IRS agent gave me about 10 working days to pay my taxes or they would put a lien on my receivables. I would be out of business.

The SBA consultant told me about "factoring," a method of financing my business by literally selling my receivables, at a discount, to an unregulated lender. It was very expensive--almost like credit card rates. But, I had no credit left on my cards. My personal credit card debt exceeded my income from the previous year. I had no choice. I sold my receivables, collected my cash, paid the IRS, and stayed in business.

Expanding the business

In January of 1997, our monthly revenue was approximately \$30,000. In May of 1997, it was approaching \$200,000 per month. We had very strong gross profit margins and a backlog of receivables from a growing list of "blue-chip," Global 1000 clients. We opened an office in Austin, which was profitable in 90 days. We were again ranked among the 25 fastest growing privately-held companies, and among the 100 fastest-growing owner-managed businesses in the Dallas-Ft. Worth area. Our revenues were \$3.8 million. We remained profitable. I hired an outside accountant, who put together our financial statements. A large regional bank extended us a credit line to finance our receivables and a working capital loan, which was used to pay off some equipment leases and release us from the factoring agreement. Life was good.

In 1998, we put in infrastructure in order to grow still larger. We slowed growth, and changed our service offering slightly. We moved to a larger facility, bought new computer systems, hired our first full-time controller, and purchased and implemented new financial reporting controls and systems. We hired a large law firm to assist us in

changing our corporate structure. We changed our name, secured Federal trademarks, updated our website, and updated our marketing material. We invested the profits in the business. Our bank merged with another large regional bank. Our revenues exceed \$4 million and we were profitable. I took a check home to my wife to pay down about one-half of our credit card debt. She cried.

Financing more growth

In January of 1999, we were growing again. One of our large clients gave us a huge contract. Although the terms of our agreement required them to pay us a portion of our fees in advance, and for subsequent payments to be made in 30 days or less, they asked us if we couldn't start while they worked out their internal cost allocation issues. I asked our recently merged bank for an increase in our receivables financing line. Although our client was an internationally known corporation and their receivable was "good as gold," the bank said "no." Their credit policies had changed. Businesses of our size were not the focus of the new, larger bank.

So, I went to our client and begged and pleaded for a faster payment schedule. It sent a bad message. "Ed, are you having financial problems?" I was asked. "We have other vendors who are not demanding we pay on the same terms. If you can't do the work, maybe we should seek another vendor for these services. Can we count on PeopleSolutions to meet our needs?" So once again we buckled down. We slowed our payments to our vendors--other small, owner-managed companies who were growing along with us. The financial pain was passed down the business chain. We made it through. But our client lost a little confidence in us. Our inability to adequately finance our business made us look small and uncompetitive.

Limited cash flow slows growth; in "no man's land"

The slowed velocity of cash flow forced us to slow our growth. Having been turned down by other banks, I sought advice from trusted, experienced businessmen. I was told to "Get some equity in your business Ed, or someone else is going to realize your dream." Friends introduced me to many different types of investors: Individual "angel" investors (quite an oxymoron, I would add); venture capitalists; investment bankers; and private equity fund managers. My business relationships put me in touch with many of Dallas' most prominent investors. I needed one million dollars for the business. No one was interested in investing a million dollars. Maybe five million, certainly ten, but our business model did not require five million. My team and I had done so much with almost nothing. I knew that one million dollars would be more than enough to get us to the next level. But no one was there at that point. We were in a financial "no man's land."

Inc. magazine notified me that we had made their 1999 list of the 500 fastest-growing companies in the United States. I started talking to potential acquirers. The thought of selling literally made me nauseous, but we were reaching a point of no return.

Financing crunch time

One day I received a letter from an investment fund located in Houston seeking to invest up to one million dollars in established companies. I called them. We talked. They were an SBIC lender. They were interested. We began negotiating.

One Friday, while I was at a trade show, my controller called. "Ed, I tried to move money from our receivables line to cover payroll, but it wouldn't transfer. We are locked out," she said. I replied, "Oh, there must be some mistake. Maybe there's some data transfer problem associated with this merger. Call Gary, the banking officer, and see what he says." An hour later, she calls me back, "Ed, Gary doesn't know what the problem is. He is going to check." My heart is pounding. Payroll goes out on Saturday, but without the bank line we would be \$50,000 short of cash to cover payroll.

My cell phone rings. It is Gary, our banking officer. "Ed, I don't know what happened. This wasn't supposed to happen. We had it all worked out. Bottom-line is that we don't control the credits here locally anymore. Your account has been transferred to California. Call this guy, in Houston. His name is Guy. He is a "special credits" person. He has the authority to reopen your credit line. Good luck."

Guy is hesitant. Although we have never been late on a payment and they've made money on us, he says our ratios don't look good. I responded, "Guy, if you don't reopen this line, my paychecks will bounce, my employees will quit, my clients won't pay, and I will be out of business. I will have no way to repay the bank what we owe. Is this a wise decision for any of us? How can you finance a business, put them on the *Inc.* 500 list and then pull the rug out from underneath them?" He reopened the line. We were forced into their factoring division and to accept an onerous repayment schedule to the bank. We had no cash to grow. It was all going back to the bank. We were back into usury interest rate financing again. Our revenue growth for the year was flat. Once again, we were profitable, but we had no cash.

Finding a financing source; continued growth

I accelerated my negotiations with the SBIC lender and with a potential acquirer. We got the best deal we could from each. I met with my team and laid out the financing options: Stay where we were; sell; or take the equity loan. We decided to take the SBIC equity loan. With one million dollars in subordinated debt to finance our business, we grew from \$4 million in revenue in 1999 to \$6.5 million in 2000. We project 2001 revenues to exceed \$10 million. Our projected year-end employment number should approach 80 professional people. We continue to be profitable, and we are no longer in financial "no man's land."

I want to emphasize that finding adequate financing at a reasonable cost and in a timely manner is a critical problem for small, emerging growth businesses. Lack of capital financing restricts growth potential for these businesses, which also limits new employment opportunities.

Bridge Act proposal--a new source of retained capital

If we had been able to take advantage of the tax deferral provisions of the proposed Bridge Act, we would have been able to retain enough capital to be more self-sufficient. We could have gotten out of the financial "no man's land" much faster. I believe that the company would be at least twice as large as we are today, employ twice as many people, and be closer to realizing my dream of creating a model working environment for American workers and a more efficient, less costly working environment for American business.

Thank you for the opportunity to testify at this hearing and for your attention to our story. I urge that the Congress enact the Bridge Act to help other emerging growth businesses get through their financial "no man's land." This will help these businesses to survive, continue growing, expand jobs, and become more productive businesses. These expanding businesses are providing most of the new jobs in our economy; keeping them in business will be good for the economy and good for the government.

Statement of

**Douglass Tatum, CEO
Tatum CFO Partners, LLP**

Before the

**Subcommittees on Tax, Finance, and Exports
and on
Workforce, Empowerment, and Government Programs
of the
House Committee on Small Business**

On June 26, 2001

**“Proposed Solutions for the Capital Funding Needs of Start-Up
and Emerging Growth Businesses”**

Introduction and Background

Good afternoon, Chairman Toomey and Chairman DeMint and Members of the Subcommittees. My name is Douglass Tatum, and I am the Chief Executive Officer of Tatum CFO Partners LLP, which is headquartered in Atlanta Georgia.

My testimony on the matters before the Subcommittees today comes from the perspective of serving as CEO of the largest CFO firm in the country with over 300 partners located geographically in 24 offices. Our partners provide CFO and CIO assistance, and serve as CFOs and CIOs for companies ranging from start-ups to Fortune 2000 multinationals. We have hundreds of years of collective experience helping growing firms cope with their challenges: raising money in capital markets; installing financial control systems; meeting payroll; and paying taxes. Our experience, particularly with emerging growth businesses, led to the publication of a brochure written by our partners, titled No Man's Land – Where Growing Companies Fail®. This brochure, a copy of which has been provided to you with my statement, provides relevant and practical insights into the unique real-world challenges of rapidly growing firms. Our partners are frequently asked to address this topic to groups of CEOs and entrepreneurs, and we have found that the concepts of “No Man’s Land” strike a resonant chord with entrepreneurs all across the United States.

The Bridge Act Proposal

With regard to the issues before the Subcommittees today, I would like center my testimony on the Bridge Act proposal and its implications for growing businesses.

We believe that the proposed Bridge Act would correct an unintended consequence in the tax code that currently has enormous detrimental effects on the economy and on job growth in particular. The Act would provide cash flow relief to a very specific and economically important taxpayer--the emerging growth company.

The Bridge Act would help emerging growth companies by allowing a firm with revenues growing by 10 percent or more above the average of the prior two years to defer up to \$250,000 of Federal income tax liability for two years, after which time the company would have four years to pay the deferred amount. Interest would be paid on the entire time of deferral. We believe that the associated revenue cost will be modest during the first few years and negligible over the remaining years of the 10-year budget estimating period. The Joint Tax Committee staff is currently preparing a revenue cost estimate on the proposal.

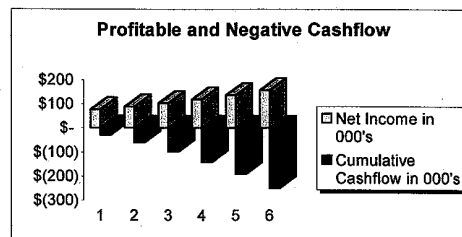
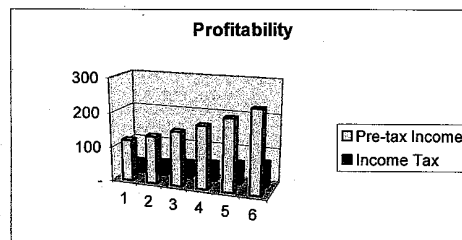
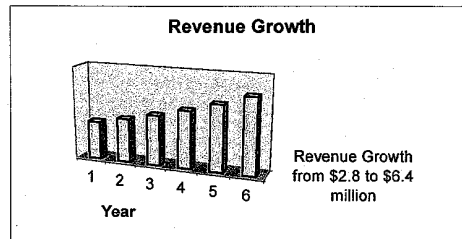
The deferral would be limited to firms that meet the growth test with \$10 million or less in gross receipts that are on accrual accounting for tax purposes. Growing firms on accrual accounting face a negative cash flow as growth increases, even as they are required to make a tax payment. (See the following Chart on the Microeconomics of Growth.)

The Microeconomics of Growth

Emerging growth companies transitioning through “No Man’s Land” are extremely fragile and face a unique set of microeconomic circumstances caused by growth. Growth in revenue drives growth in assets, creating demand for capital and a perpetually cash-starved business—even with significant profitability as outlined in the first series of charts below.

Microeconomics of Growth

The following illustrations were built from an economic model that accounts for the typical asset growth characteristics of a rapidly expanding business on accrual accounting and transitioning through "No Man's Land."



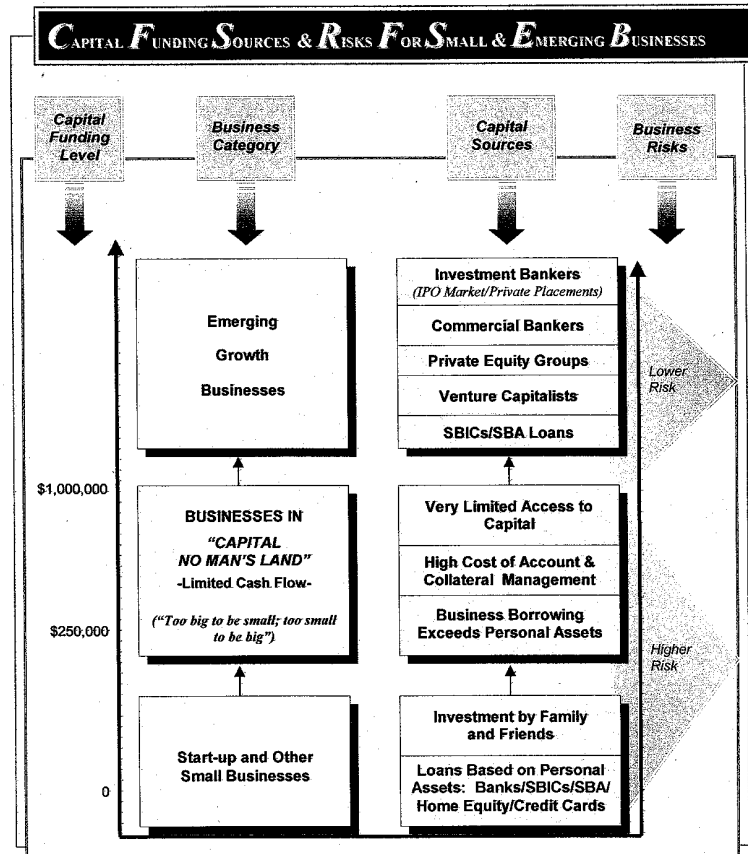
As the microeconomic growth illustrations suggests, current tax policy compounds the difficulty in retaining critical capital during the high-growth phase because it requires an expanding business to pay taxes on reported income while its cash flows are inherently negative under accrual accounting. These firms are "too big to be small and too small to be big." As I testified to the full Small Business Committee in May, these firms are subject to strict rules-based lending criteria that often excludes emerging growth companies from the type of financing that is essential during expansion.

Capital Funding Gap

The second chart below illustrates the availability of capital to businesses in what we define as the "Capital No Man's Land," that is, with capital funding needs generally between \$250,000 and \$1 million. This chart indicates that capital funding in this range is very difficult to obtain where business borrowing needs exceeds the personal assets of the business owner(s). There is also the high cost of account and collateral management for loans of this size, compared to loans of \$1 million or more.



ILLUSTRATION OF "CAPITAL FUNDING GAP"



06/22/01

The cumulative result of these two challenges that uniquely impact emerging growth businesses—(1) the negative cash flow caused by the microeconomics of growth and (2) the Capital Gap—is that emerging growth businesses may not generate sufficient cash flow, even as they enter their profitable years, to cover income tax liabilities. We believe that the tax burden alone is enough in many cases to cause a company to lose its economic momentum.

The Importance of Emerging Growth Businesses to the U. S. Economy

Emerging growth companies are enormously important to the Nation's economy. According to recent studies by the Kauffman Center for Entrepreneurial Leadership ([Global Entrepreneurship Monitor](#), 1999 and 2000) and Cognetics, Inc., more than 90 percent of the growth in new jobs in the past decade has come from emerging small and mid-size entrepreneurial companies (companies with under 100 employees). These rapidly growing firms have been at the forefront of innovation in the economy. They represent all sectors of the economy.

In Summary

The Bridge Act would effectively create a "Tax Deferred Zone" that would correct the unintended consequences of current tax policy and would have a positive and substantial impact on the most significant job-creating segment of our economy. It would lead to higher tax revenue by encouraging continued growth of profitable enterprises. The Bridge Act is non-discriminatory, and would apply to all regions of the country and to all industries where there are significant growth opportunities. We believe that this legislation will create passionate support from the large constituency of individuals who are leading their companies through the challenges of growing their businesses. These businesses represented the economic engine of the past decade; and this same engine is poised to drive our economy in the future.

Congressmen Jim DeMint (SC) and Brian Baird (WA) and their staffs, and others, have been very helpful in developing and refining a tax deferral proposal for emerging growth businesses. We hope that Congress will give the proposal careful consideration at the appropriate time when the proposal is introduced as a bill in the near future.

Concluding Comments

In conclusion, I would like to thank each of you for the opportunity to appear before these Subcommittees on this important topic. I will be glad to attempt to answer any questions you may have.



NO MAN'S LAND

WHERE GROWING COMPANIES FAIL

NO MAN'S LAND

Where Growing Companies Fail INTRODUCTION

No Man's Land is that time in every company's life when it faces perhaps its greatest challenge - the challenge of growing up. It is the adolescent stage of corporate growth. Like human adolescence, No Man's Land should be a place of self-discovery, acquired discipline, and positive but difficult transition. Unfortunately, it often becomes an agonizing battle between the natural tendencies of a lonely entrepreneur and certain immutable laws of growth. The result is confusion, frustration, stagnation, and loss of employee morale which, if prolonged, lead to financial failure.

Through the years, we at Tatum CFO have observed a recurring phenomenon. Most entrepreneurs are simply unaware of No Man's Land. Furthermore, they are unaware that certain of their own natural tendencies prevent long term growth. This is understandable, for it is these very same tendencies, oddly enough, that have been the basis of their success to date.

Our purpose in writing this booklet is to identify four steps that must be taken in No Man's Land. We firmly believe that once taken, a company will have the foundation for unprecedented economic growth. We call these steps the "4 M's of Growth:"

- *Understand Your **MODEL***
- *Realign With Your **MARKET***
- *Hire Your Senior **MANAGEMENT***
- *Raise Your **MONEY***



NO
MAN'S
LAND



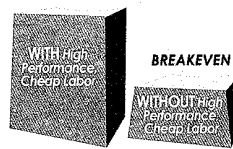
Understand Your Model

AN EXAMPLE: CHEAP LABOR

When customers are asked why they do business with an emerging company, they often answer "service." Most companies attract their first customers through high performance, cheap labor. Essentially, an entrepreneur and a loyal core of employees work harder to provide superior product and service less expensively.

But sustained growth cannot depend on a competitive advantage gained through high performance, cheap labor. The unrelenting economic reality is that a company must eventually grow with mostly average skilled people paid normal wages. This represents a fundamental change in a company's business "model." Without high performance, cheap labor, a company may no longer have a set of competitive advantages that provides enough customer value to earn a profit. If so, the company's business model does not permit growth. In fact, a company whose only competitive advantage is high performance, cheap labor must remain small to survive.

Customer's Perceived Value of Product/Services



This transition from high performance, cheap labor to normal labor is but one example of many other changes and decisions that redefine a company's business model as it grows. The main point is that a company must first fully understand its existing business model and then constantly analyze it. By doing this, the company continuously subjects itself to a financial reality test, a discipline required for profitable growth.



**TEST WHETHER
YOU ARE IN NO
MAN'S LAND -**

- Are you experiencing unprofitable growth because the growth rate of overhead is exceeding the growth rate of sales?
- Are your employees misinterpreting sales growth as profit thereby raising their compensation expectations?
- Do you know the true cost of each individual product and service?
- Have you factored in the real cost of adding sales into your growth plans?
- Are you feeling an inability to follow through on compensation promises to employees?
- Do you know how much additional cash you will need to fuel accelerated growth?

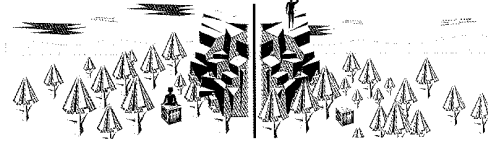
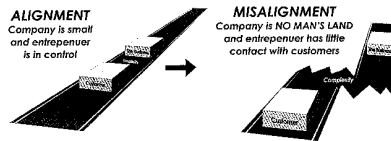
Realign With Your Market

AN OBJECTIVE PERSPECTIVE

In its early stages, a company is driven by the entrepreneur's unique personality, skills and understanding of the market. Its business is characterized by a simple, non-filtered exchange between the customer and a single point of contact, the entrepreneur. The hands-on entrepreneur ensures that products, services and operations are aligned with customer needs. The entrepreneur directs quick changes to satisfy a specific customer. The result is that the company is simple for the customer to do business with and the customer receives the unique value of the company's products and services. The company is essentially market driven because of alignment.

With growth, the demand on an entrepreneur increases. Whether it's managing accounting staff, seeking capital or putting out fires in operations, less contact with customers occurs.

The entrepreneur then becomes personally unable to maintain alignment. The result is that simplicity no longer characterizes the customer's relationship with the company. Ultimately the company loses its competitive advantage and its sales stagnate.



In order to continue growing, a company must realign with its market. Realignment begins only when an entrepreneur gains an objective perspective of the business and recognizes it is misaligned with its market. Once achieved, this objectivity leads, often for the first time, to identifying the company's real and potential competitive advantages. The understanding and analysis of one's business model is also fundamental to this process.



TEST WHETHER YOU ARE IN NO MAN'S LAND -

- Do customers only want to deal with you?
- Is there undue stress between sales and operations?
- Do you have dissatisfied customers?
- Are you forever putting out fires?
- Are you having difficulty distinguishing your products and services from that of your competitors?
- Have your sales stagnated?
- Do you have an apparent lack of competitive advantage?
- Are you living on past reputation?
- Are you bored with your core business and beginning to focus on new products and services?
- Do new products and services reflect your personal interests and not necessarily your customers' needs?

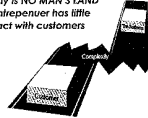
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Hire Your Senior Management

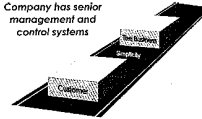
THE HOUR GLASS

An entrepreneur can maintain alignment and ensure simplicity for customers when a company is small. However, once alignment is lost in a growing company, gaining it back requires senior management and a control system. The entrepreneur must hire and delegate to senior management the responsibility of implementing and managing this control system.

MISALIGNMENT
Company is NO MAN'S LAND
and entrepreneur has little
contact with customers

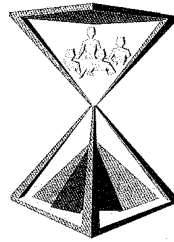


REALIGNMENT
Company has senior
management and
control systems



Certain unique, customer oriented skills must also be delegated to this senior management structure. The entrepreneur's focus must change from doing to designing and possibly from creating to managing others' creativity. What the entrepreneur does well, the organization must learn to do well.

Delegating to senior management is the most difficult transition for an entrepreneur. Fear of losing control is the primary reason. Ironically, delegating to senior management is the only way to gain back control. Furthermore, it achieves an "hour glass" organization structure which provides the essential management expertise to get through No Man's Land.





TEST WHETHER YOU ARE IN NO MAN'S LAND -

- Is your company outgrowing the abilities of certain long-term loyal staff?
- Is everybody waiting on you to do something?
- Are you the only "senior" management?
- Are you not allowing people the authority to make mistakes?
- Is your company confused with priorities and direction?
- Do you have too many meetings?
- Do you fear losing control to new management?
- Are there dotted lines in your organizational structure?
- Does your staff feel you attempt to implement your most recently read management theory?

9

Raise Your Money

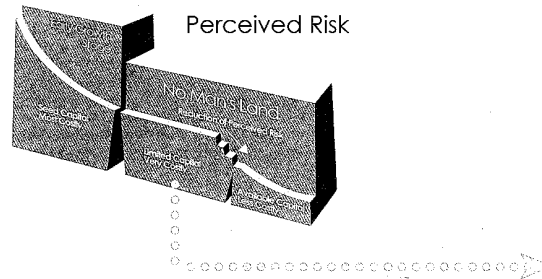
REDUCING PERCEIVED RISK

Most companies enter No Man's Land without enough capital to leave it. If and when they fail, "undercapitalization" becomes the blame. But undercapitalization is really not the cause. It is instead a fatal symptom of another cause: a company's inability to raise capital because it is perceived as too risky; or in our words, it is perceived as unable to escape No Man's Land.

While a company may have tremendous upside potential, in order to raise money it must focus on reducing its perceived risk; or in other words, it must prove that it can indeed escape No Man's Land. However, proving this to the appropriate capital sources is impossible unless a company takes certain real steps related to:

- *understanding its **MODEL**;*
- *realigning with its **MARKET**; and*
- *hiring senior **MANAGEMENT**.*

Once specific steps are taken, the perceived risk is lowered and capital becomes available to the company.





**TEST WHETHER
YOU ARE IN NO
MAN'S LAND -**

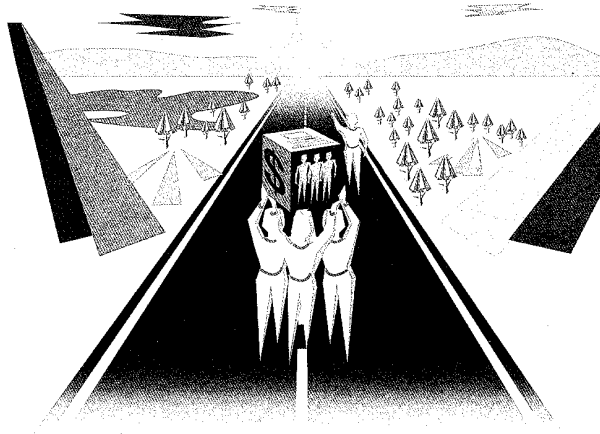
- Are you experiencing poor cash flow?
- Have you been repeatedly turned down by banks and others for financing?
- Are you unable to make needed capital investments?
- Are you unable to hire key people because they view the business as too risky?
- Are you unable to recruit key people because you cannot afford to pay them?

NO MAN'S LAND

Where Growing Companies Fail SUMMARY

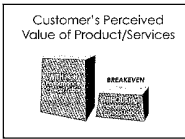
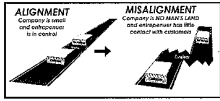

The growth that leads a company into No Man's Land will not lead a company out of it. Successful passage requires entrepreneurs to step away from day-to-day operations and honestly evaluate themselves and their companies in light of the "4 M's of Growth" outlined in this booklet. Only then can an entrepreneur begin redirecting corporate energies to transition the company to the success that lies beyond.

Our firm salutes the tough and creative resourcefulness of those men and women we have worked with over the years who have enjoyed successful passage through No Man's Land. We at Tatum CFO sincerely hope that the principles set forth in this booklet will assist other entrepreneurs in exiting No Man's Land and ultimately realizing their own corporate visions.



The Road To Success

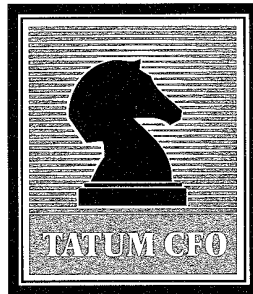
NO MAN'S LAND

| | THE MODEL | THE MARKET |
|------------------------------|--|--|
| Core Issue | A business model quantifies a company's true economic potential for growth as well as the required resources for such growth. Market forces, management decisions and changes in performance will dramatically alter a company's original business model as it grows. | A company's products, services and operations must be aligned with its market at all times. When a company is small, the entrepreneur ensures alignment. As it grows, the demands on the entrepreneur are such that the entrepreneur can no longer ensure alignment. |
| Key Illustrations | <p>Most companies are built during their formative stages on high performance, cheap labor. Essentially, the entrepreneur and a core group of loyal employees work harder to provide superior service. However, the unrelenting economic reality is that eventually normal wages must be paid for average performance. This is merely one example of a market force that will fundamentally change a company's business model as it grows.</p>  <p>Customer's Perceived Value of Product/Services</p> | <p>Growth invariably drags an entrepreneur into many of the day-to-day issues related to operations, accounting, finance and personnel. The result is that the entrepreneur loses touch with the customer and the market.</p> <p>Without the entrepreneur performing the role of personally processing the changing needs of the customer and ensuring alignment, the company drifts into misalignment. The litmus test of alignment is that the relationship between the customer and the business can be characterized as simple in all respects.</p>  |
| Key Transition | <p>A company must first understand its current business model and then discipline itself to continuously quantify the impact of on-going changes to the model that result from -</p> <ol style="list-style-type: none"> 1) market forces; 2) company performance; and 3) management decisions. | <p>When misalignment occurs, realignment must begin. This requires the entrepreneur to extricate himself or herself from the day-to-day and gain an objective perspective of the business once again. Gaining an understanding of the company's business model is also crucial to this process.</p>  |
| Questions to Consider | How long has it been since you have modeled in great detail the financial parameters of your business? Have you made any key decisions lately without the confidence of knowing its financial impact? | Do you have the same perspective of your business and its market as you did when it was much smaller? Would you say that simplicity describes the relationship between your customer and your company? |
| 14 Key Principle | Understand your MODEL. | Realign with your MARKET. |

A Summary of the 4 M's of Growth

| THE MANAGEMENT | THE MONEY |
|--|--|
| <p>Once a company recognizes it is misaligned, the process of realignment and maintaining alignment cannot be performed by the entrepreneur any longer. This is also true of certain specific skills that have been performed by the entrepreneur often since the company's inception.</p> <p>An entrepreneur acting as the sole senior manager of a company is responsible for maintaining alignment, managing operations, and raising capital, while also performing his or her unique skill set.</p> <p>When a company is small, these demands are both less in number and relatively simpler. As a result, they can be performed and managed, often by intuition, effectively. Growth, however, exponentiates the issues for management to assimilate and address. Only a control system and a senior management structure can effectively perform all these essential functions.</p> <div data-bbox="492 764 743 865"> </div> | <p>A company in No Man's Land typically does not have enough capital to exit No Man's land.</p> <p>In No Man's Land, the entrepreneur will attempt to obtain financing from various sources. Given the company's success to date, the entrepreneur becomes discouraged when efforts prove unsuccessful. However, the problem is not because the company does not represent a promising upside. Rather, the company is perceived as too risky.</p> <p>Therefore, if the perceived risks can be reduced, affordable capital becomes available.</p> <div data-bbox="906 743 1110 865"> </div> |
| <div data-bbox="435 877 565 1041"> </div> <p>To gain back and maintain alignment, the entrepreneur must hire and delegate to senior management the responsibility of implementing and managing a control system. Certain specific skills of the entrepreneur must also be delegated so the company can acquire these same skills.</p> | <p>To successfully obtain needed capital, the company must reduce its perceived risk to capital sources. This is accomplished when it takes certain real steps to -</p> <ol style="list-style-type: none"> 1) understand its Model; 2) realign with its Market; and 3) hire its senior Management. |
| <p>Have you designed your company's internal operations to run efficiently, but at the expense of losing a relationship with your customers that is simple? Do you give your senior management enough authority to make mistakes?</p> | <p>What steps can be taken in these three areas to reduce your perceived risk?</p> |
| <p>Hire senior <i>MANAGEMENT</i> and let them manage.</p> | <p>Take real steps to reduce your perceived risk so you can raise needed <i>MONEY</i>.</p> |

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**Hearing on
Capital Access Options for Small & Emerging Businesses
The Start-Up Success Accounts Act of 2001 (H.R. 1923)
And
BRIDGE Act Proposal**

**Testimony Presented before
The United States House of Representatives
Committee on Small Business
Subcommittee on Tax, Finance and Exports
The Honorable Pat Toomey
Chairman**

June 26, 2001

**Presented By
Karen Kerrigan
Chairman
Small Business Survival Committee**

On behalf of the Small Business Survival Committee (SBSC) and its nationwide membership, I am pleased to have the opportunity to testify on the issue of access to capital for small and emerging firms and how the Congress can address this challenge through the Start-Up Success Accounts (SUSA) Act of 2001, H.R. 1923, and the Business Retained Income During Growth and Expansion (BRIDGE) Act. I am Karen Kerrigan, Chairman of SBSC, a nonpartisan, nonprofit small business advocacy organization headquartered in the nation's capital.

Let me thank you Chairman Toomey for your examination of the critical issue of access to capital for small firms. Our organization is grateful for your focus and determination on this issue, as it is vital for the growth, success and survival of small business owners and entrepreneurs. SBSC is pleased that the Congress continues to place the needs of small business at the top of its agenda, and we remain enthused by bipartisan initiatives such as the SUSA Act of 2001 (H.R. 1923), which would make a meaningful difference for many young enterprises across the country. We are also encouraged by the creativity and contemplation that has gone into the proposed BRIDGE Act – a solution for entrepreneurial, emerging growth

firms that provide much of the innovation and high-paying jobs that drive our economy and keep the U.S. competitive in the world marketplace.

Access to capital remains a serious obstacle for many small firms, as the full Small Business Committee learned in its hearing on May 17, 2001. The testimony presented by expert witnesses was compelling and serves to support the follow-up hearing today on specific ways that the Congress can help firms during the start-up and growth period acquire the capital funding they need to endure.

When Representatives Jim De Mint and Brian Baird introduced the original SUSA Act in the last Congress, SBSC strongly supported the proposal, and we continue to believe that it remains a creative and common sense solution that would assist many small businesses through the tumultuous and challenging early years of their development.

Because the tax code discourages capital retention, many small businesses are often faced with cash shortfalls at critical phases. These periods include times when a business needs extra capital for expansion and growth; or cycles when business activity many slow down and there is little flexibility

in managing fixed expenses; or simply periods of adjustment when the business needs an infusion of cash to react to changes in the marketplace. The SUSA option, whereby new small businesses would be allowed to place up to 20% of taxable income into tax-deferred savings accounts for each of the first five years of operation, opens up new financial planning and financing opportunities for small firms most in need of these tools.

As most committee members know, many banks require a documented track record of success while venture capital and angel relationships are competitive. The networks are often difficult to penetrate. Unfortunately, the tremendous success of venture funds in raising significant amounts of capital have made small investments less attractive. This means that small businesses need more tools to be self-reliant for their capital needs. A few years ago, the Center for Venture Research of the University of New Hampshire “estimated that about 300,000 growing companies and about 50,000 start-ups need equity capital each year” in an analysis it conducted for the Small Business Administration. CVR projected that total funding needs for these companies amounted to \$60 billion.

The SUSA Solution would help small firms get out of the trap of “passing

through” excess capital to avoid double taxation, subsequently followed by a frenzied search for capital to grow the business or keep it afloat. The owner/entrepreneur can spend an inordinate amount of time and resources seeking such capital during times of need. The SUSA alternative, in this regard, promotes self-sufficiency and efficiency.

The BRIDGE Act is a complimentary proposal to SUSA tackling the same problem faced by new and growing firms, yet its distinction is apparent in the type of business that it would benefit – the rapidly growing, entrepreneurial firms that create the bulk of new jobs in the U.S. Access to capital is not only a challenge for the smallest of firms, or the entrepreneur who wants to take her idea to the marketplace, but is a major problem for the “gazelles” whose activity and rapid growth require an ongoing infusion of capital.

As Douglass Tatum, CEO of Tatum CFO Partners, pointed out in his testimony before the full Small Business Committee on May 17, the lack of available capital at a reasonable cost is a critical problem facing entrepreneurs. This concern was drawn from focus groups conducted by the The National Commission on Entrepreneurship with over 250 CEOs of

entrepreneurial firms across the country. The impressive success of a start-up to the level an “emerging company” indeed is an exciting triumph, but it still comes with the exact same problem faced by entrepreneurs who are just starting out – access to capital. Incredibly, the health of the U.S. economy and the constancy and growth of the workforce employed by emerging businesses depends upon the ability of these company leaders to successfully attract capital. To this end, SBSC believes Congress should be doing all it can to help these firms grow, succeed and thrive. Given that the greatest growth in employment has come from emerging and small and mid-size entrepreneurial firms, it only makes sense that policymakers find ways to help them succeed. The BRIDGE Act is a reasonable and fair approach to help keep these businesses afloat, and more importantly, grow.

The Bridge Act proposal aims to help emerging growth businesses -- those growing by 10% or more above the prior two years sales revenue -- through retaining their own funds for a temporary period for continued growth. The proposal would allow the growing firms to defer payment (with interest) of up to \$250,000 of Federal income tax liability for two years, after which payment would be made over a 4-year installment period. The deferral

would be limited to growing firms with \$10 million or less in gross receipts that are on accrual accounting for tax purposes.

Under the current draft proposal, the tax-deferred amount would be deposited in a separate trust account at a bank or other approved financial institution, and the firm could use the deferred amount as collateral for a business loan. From SBSC's point of view this would encourage establishment of an early banking/borrowing relationship as emerging growth companies expand their businesses. The additional capital provided by the tax deferral account would help the company to survive the "capital gap" that small, growing firms go through in order to thrive as a going business concern -- before they can more readily obtain capital financing from external sources as they grow larger.

SBSC urges the both the Small Business Committee and the Congress to give favorable consideration to the Bridge Act proposal. It is a "pro-growth, pro-job" policy initiative that will benefit all sectors of the economy.

Small business ownership is a goal that more Americans are actively pursuing. SBSC believes we are very fortunate to live in a country where our

system of government encourages our elected officials to identify areas where public policy can help create a more favorable environment for entrepreneurship. Indeed, there are many steps that can be taken to help America's small business sector, and the two "capital access" proposals being studied by the committee today can make a positive difference for the overall stability of our vibrant small business sector and their dedicated workforce if implemented.

It is SBSC's position that there is a great need for both the SUSA Act of 2001, and the BRIDGE Act. Both of these initiatives are sound approaches toward equipping small and emerging firms with options that allow each to more independently address their capital needs.

I congratulate Representatives Jim DeMint and Brian Baird for their ongoing cooperation in pursuing the SUSA Act of 2001 in the 107th Congress.

SBSC supports this initiative and looks forward to working with Members of the U.S. House of Representatives to advance its passage. We also applaud Congressman DeMint for his dogged pursuit of creative ways that Congress can assist small and emerging firms through his BRIDGE Act

proposal. And Chairman Toomey, we thank you for your leadership in keeping this issue before the Congress.

I look forward to answering questions from Committee members.

Testimony of
Bob Morgan, President,
Council of Growing Companies
Before the
Subcommittee on Tax, Finance, and Exports
And
Subcommittee on Workforce, Empowerment, and Government Programs
Of the
House Committee on Small Business
On June 26, 2001
“Proposed Solutions for the Capital Funding Needs of Start-Up and Emerging Growth Businesses”

Introduction

Good afternoon, Chairman Toomey and Chairman DeMint. My name is Bob Morgan, and I am President of the Council of Growing Companies, headquartered in McLean, Virginia. The Council of Growing Companies (the “Council”) represents more than 1200 member CEOs of rapidly growing, entrepreneurial firms: firms with annual revenues ranging from a minimum of \$3 million to over \$1 billion. These firms are experiencing double-digit annual growth in revenue and number of employees, and frequently are recognized as winners of the Inc. 500 or the Deloitte & Touche Fast 50.. We have members throughout the United States and abroad. The Council’s primary focus is to serve the informational and educational needs of the CEOs of these emerging enterprises. The Council brings members together in chapters in most cities, links them internationally with private electronic networks, and conducts conferences and programs that facilitate the exchange of best practices and top business resources. We are a

collective voice for entrepreneurs in public policy discussions, and strive to create a social, economic, and political environment that nurtures entrepreneurship.

My comments today will focus on the capital needs of, and a proposed tax solution for, emerging growth companies.

Capital needs of emerging growth businesses and small businesses

It is important to distinguish between “small businesses” and “emerging growth businesses.” Small businesses are important to the economy, because there are so many of them. However, most small businesses remain small, and do not face the same capital funding needs as for a growing business. The National Federation of Independent Business testified at the May 17 House Small Business Committee hearing that capital financing was not one of the highest priority issues for their members. Many of these small businesses can obtain financing in relatively small amounts (under \$250,000) based on the owner’s personal line of credit, or from family and friends and credit cards (based on the personal assets of the individual, rather than on the business assets).

However, when an entrepreneurial business begins to grow significantly, it quickly outgrows the personal asset-based financing of the entrepreneur and family sources. Rapid growth requires constant attention of the entrepreneur, and the business capital financing becomes based more on the assets of the business, rather than the individual owner(s). Sales growth requires reinvestment in inventories, equipment, and new employees to get the job done in a timely manner to meet customer needs. Lack of capital can hinder the growth potential of the company, and the company can stagnate if it does not obtain the needed capital to continue its growth.

Access to capital for emerging growth businesses is very limited for external financing below about \$1 million, due to the cost of papering such relatively small amounts and due to the risk factor to the lender. Once a growing business can qualify for a loan or credit line of \$1 million or more, the capital markets open up because the firm has enough assets to support the credit and the relative cost of managing the loan goes down.

Proposed tax solution for emerging growth “capital gap”

It is not commonly understood that a growing company can be profitable, and thus owe income taxes, and yet become cash flow negative. This is the case for rapidly growing firms on accrual accounting for tax purposes. They report a taxable profit under accrual accounting, but if their sales growth rate exceeds the return on assets, they become cash flow negative. A growing firm reports on accrual accounting due to tax requirements at a certain revenue size and also because of the requirements of outside capital sources (which require audited, accrual basis financial statements). The growing firm uses up its internal capital by reinvesting in the company’s growth.

The Bridge Act proposal would help emerging growth companies with up to \$10 million in gross receipts to retain their own capital in the company at a critical time when the future of the company may be jeopardized due to the lack of outside capital. The proposal would permit those companies on accrual accounting for tax purposes to defer payment (with interest paid on the deferral) of up to \$250,000 of Federal income tax liability for two years after the year of deferral. After the two-year period, the deferred amount would be paid over a 4-year period. Thus, the proposal is not a tax deduction or tax credit, but rather a deferral with interest paid.

Under the draft proposal, the tax-deferred amount would be deposited in a trust account at a bank or other financial intermediary, and the company could use the account as collateral for a business loan. The collateralized account would make the business loan less risky for the lender, and would help to establish an early financing relationship between the lender and the company. Thus, this collateralized capital would help such growing companies to keep “going and growing” until they can attract more financing at a reasonable cost.

Concluding comments

The Council urges the Members to support the Bridge Act proposal in any small business tax package that is considered in this Session. This proposal will have considerable positive effects on the economy by helping emerging growth companies to stay in business and to keep expanding their sales and employment. These emerging growth companies have been, and continue to be, the net producers of most of the new jobs created in our economy—particularly, as larger firms are downsizing. This proposal will have a significant multiplier effect on the economy, which is currently in need of more growth.

Thank you for the opportunity of testifying here today on this important issue. I will be glad to try to answer any questions you may have on the importance of capital access for emerging growth businesses.



BIOGRAPHY

Robert S. Morgan
President
Council of Growing Companies



Robert S. Morgan joined the Council of Growing Companies in 1993. The Council, a non-profit professional organization exclusively for CEOs of emerging growth companies, is dedicated to serving the networking, educational, informational and public policy needs of member CEOs. Prior to joining the Council, Morgan served as Chief Operating Officer of the Susan Davis Companies (SDC) from 1990 to 1993. Prior to that, Morgan had a lengthy career at AT&T, including serving his last four years there as the Public Affairs Director, representing all AT&T entities to various units in the executive and legislative branches of the federal government. He was also AT&T's liaison to such organizations as the United States Chamber of Commerce and the Business Roundtable.

Following college, Mr. Morgan joined what was then the Bell Telephone System, working for the Chesapeake and Potomac Telephone Company in Washington, DC. He advanced through various positions, including Division Manager for Metropolitan Washington, General Personnel Supervisor, General Marketing Supervisor, General Manager of Directory Operations, Assistant to the President, General Public Affairs Supervisor, and General Manager of Headquarters Central Staff for C&P. He then went to the AT&T general departments and was head of personnel and administration for the consumer products division. At divestiture of the Bell System, he became head of the marketing staff for the eastern region of the United States.

Mr. Morgan attended Northwestern University and received a Bachelor of Science of economics from West Virginia University. He completed graduate work at Carleton College and completed the advanced marketing program at Wharton. His Certified Association Executive (CAE) designation was earned in 1995.

Mr. Morgan is Chairman of the Greater Washington Society of Association Executives, a member of the Board of Directors of the Small Business Legislative Council, the Greater Washington Board of Trade, Synthesis Partners LLC, NeteXc Information Services and Beacon, International. He also is a member of the Committee of 100 and an Inner Circle member of the Dingman Center for Entrepreneurship, at the University of Maryland. He is a member of the U.S. Chamber of Commerce and the Small Business Exporters Association. He is a founding partner of the Business Coalition on Education Reform, the Welfare to Work Partnership, and the Entrepreneurs Coalition. He also served as chairman of the Board of Governors of the Business Council on Regulation and Paperwork from 1986 to 1990. He is a past member of the Public Affairs Council, where he served on the Board of Directors. He has been a past director of the Washington Capitol Area United Way Campaign, and the National Alliance of Business Jobs Campaign. He was included in "The Power 30" list in the September 2000 issue of Fortune Small Business magazine.



NASBIC
America's Small Business Partners

Statement Of
Lee W. Mercer
President

**National Association of
Small Business Investment Companies**

Before The

Subcommittees On
Tax, Finance, and Exports

&
Workforce, Empowerment, and Government Programs

Of The
United States House of Representatives
Committee on Small Business

June 26, 2001

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Chairman Toomey and Representative Pascrell, Chairman DeMint and Representative Millender-McDonald, and members of the respective Committees:

Access to Capital - Introduction

On behalf of the National Association of Small Business Investment Companies, I appreciate the opportunity to testify today concerning access to capital by small businesses. Small Business Investment Companies, the foundation of one of the government's most successful finance programs, were first created in 1958 in response to a Federal Reserve Board finding that lack of patient capital for America's small businesses was an impediment to economic growth. The SBIC program became the cornerstone for the overall venture capital industry in this country and continues to play a critical role in providing debt and equity capital in the \$250,000 to \$1,000,000 range that is of concern at this hearing. In FY 2000, SBICs invested \$5.5 billion in 3,060 small businesses in 4,639 separate transactions. The average size of investment was \$1,200,000; the more important median size of investment was \$250,000. The average number of employees in companies receiving SBIC financing was 125; the median number of employees was 25. Finally, 63% of all dollars invested by SBICs in FY 2000 were invested in small businesses that had been in business for less than three years. Clearly, the SBIC program is focused directly on the area of concern at today's hearing and I have provided more FY 2000 SBIC statistics as an attachment to my testimony.

Notwithstanding the success of the SBIC program, it is clear that lack of access to capital is still a major issue for hundreds of thousands, if not millions, of small businesses every year. The Bureau of Census reports that there were 5.8 million non-farm businesses (excluding the self-employed as well) in 1999. Using estimates made by SBA's Office of Advocacy (which should hold relatively true today), approximately 89% of those businesses had fewer than 20 employees. The percent jumps to 98% if "fewer than 100 employees" is used as the marker, and to 99% if the standard "fewer than 500 employees" definition is used. Given these numbers and the importance of small business to America's overall economic health, it is appropriate that Congress continually revisit the issue of access to capital.

Stating that as many as 5.75 million small businesses existed in 1999 (and the number is greater today) does little to capture the battle that is fought and lost each year by those small businesses that close their doors. SBA estimates that as many as 263,000 small businesses that described themselves as "unsuccessful" or "bankrupt" closed in 1999. Fortunately for the country, in that year, as in all but five years since 1988, more small businesses were started than closed. However, the question remains: of the unsuccessful or bankrupt small businesses that closed their doors in 1999, how many were good businesses that would have succeeded but for the lack of adequate capital? And further, what reasonable steps might Congress take to make more capital available?

Congress Can Increase Small Business Capital Availability Through The SBIC Program

One answer to the question of what Congress might do to increase the availability of capital is the SBIC program. At no increased cost to taxpayers, Congress could pass two pieces of legislation this year that would make substantially more capital available to worthy small businesses in the individual amounts of concern here today. First, we hope the Small Business

Committees of the House and Senate will come to agreement with their respective Appropriations Committees on a combination of a fee increase and an appropriations amount that would make \$3.5 billion in leverage available to Participating Security SBICs in FY 2002. That total would be \$1.5 billion—or 75%—more than is available this year. The demand by current and aspiring SBICs that would deploy this capital exists because there are more good small businesses for SBICs to invest in than there is current capital available to invest. When coupled with required private capital, the \$3.5 billion will mean \$5.3 billion in investments made over the next few years by SBICs that make equity investments that have an average size of \$900,000 and a median size of \$500,000. Further, because equity almost always serves as the foundation for more senior forms of financing (such as bank loans) the \$5.3 billion will have a substantial multiplier impact. The multiplier can be as much as 3 to 1 for a company with positive cash flow. Thus, \$5.3 billion could stimulate an additional \$15 billion in capital—a total of \$20 billion—for small businesses. At most, the appropriation required would be the same \$26.2 million appropriated last year. Few programs if any can claim this type of positive leverage and the SBIC industry strongly urges Congress to take this step.

The second SBIC-related legislative action that Congress could take to increase the size of the SBIC program, and therefore the amount of capital available to small businesses, is to pass a NASBIC-sponsored proposal that would amend the Internal Revenue Code (IRC). The amendment would declare that government-guaranteed capital (leverage) borrowed by Debenture SBICs to augment their private capital (and thus form the corpus of their investment funds) is not “acquisition indebtedness” that the IRC says creates Unrelated Business Taxable Income (UBTI) for tax-exempt investors. Debenture SBICs are important sources of subordinated debt capital for small businesses, making investments that currently average \$435,000 in size, with the median size at just \$150,000. Like equity investments, subordinated debt investments often are the foundation for more senior debt. The amendment to the IRC would benefit all Debenture SBICs, including the minority oriented Specialized SBICs, in their private fundraising activities, thus helping to increase the size of the Debenture SBIC program and, therefore, the amount of important subordinated debt capital available to small businesses. I have expanded on this proposal in the final section of my testimony.

BRIDGE and SUSA - Innovative Proposals That Complement The SBIC Program

Finally, and with appreciation of the creativity involved, I commend Chairman DeMint and other supporters of the proposed Start-Up Success Accounts (SUSA) Act and the Business Retained Income During Growth and Expansion (BRIDGE) Act for attacking the problem of inadequate capital at one of its earliest and seemingly unlikely events: the first time a small business has taxable income. If enacted, either piece of legislation would help self-selected successful young companies with cash flow problems associated with growth. It is perhaps counterintuitive that success, the very thing we applaud in all young companies, should lead to an early and critical need for cash that some businesses simply cannot overcome, but it is true.

Both pieces of legislation are unique in that they would require no government involvement other than record keeping and no expenditure of scarce time in an application process by intended recipients. Nor would capital benefits flow to any undeserving recipients. The beneficiaries of the program would prove their merit and qualifications by actually producing taxable income. They differ in approach (income deferral under SUSA, tax deferral (with

interest) under BRIDGE), with respect to the size of the small businesses that would likely benefit most from their respective provisions (very small under SUSA, much larger under BRIDGE), and with respect to whether or not a threshold level of growth should be required. However, both have as their foundation the belief that successfully growing small businesses should not be unfairly punished by rigid application of tax laws and accounting rules during the earliest stages of that growth.

Both pieces of legislation should be considered complementary to the SBIC program. Designed by the government to be profit-oriented entities, SBICs invest in only the best opportunities they are presented with. That does not mean that small businesses that do not receive SBIC financing (or financing through one of the other SBA programs) may not be deserving of support. It simply means there are more small businesses deserving support than there are sources of that support. For example, on average, SBICs invest in perhaps 1.0% of the potential investment proposals they receive, with e-mail having greatly increased the number of proposals received. Thus the 3,060 companies that received SBIC financing in FY 2000 there were likely among over 300,000 proposals (without adjustment for multiple submissions) that may have submitted for consideration in one form or another. We also know that there are hundreds of thousands of small businesses that for one reason or another do not have business plans—an absolute requirement for investment consideration. The proposed legislation would give many worthy companies in these categories financial breathing room—without the necessity of creating ill-advised capital structures to accommodate an “emergency” capital source—to prepare for professional presentations to investment professionals that will support them over time.

Further Expansion on Unrelated Business Taxable Income & Debenture SBICs

NASBIC has proposed amending the Internal Revenue Code (IRC) by adding the following as IRC §514(c)(10):

- (10) INDEBTEDNESS INCURRED BY DEBENTURE SBIC. For purposes of this section, the term “acquisition indebtedness” does not include the indebtedness of a small business investment company licensed pursuant to the Small Business Investment Act of 1958 that is evidenced by a debenture issued by the small business investment company pursuant to Section 303(a) of the Small Business Investment Act of 1958 or held or guaranteed by the United States Small Business Administration.

Background and Discussion

Small Business Investment Companies (SBICs) are government-licensed, government-regulated, privately managed venture capital firms created by the government to invest only in original issue debt or equity securities of U.S. small businesses that meet size standards set by law. SBICs were created to provide venture capital needed by small businesses to create jobs and technologies that are the cornerstones of the U.S. economy. The investment limitations on SBICs differentiate them from non-SBIC venture funds, funds free to invest in any company—large or small, foreign or domestic.

To become a Debenture SBIC and gain the program’s benefits—augmentation of private capital by access to government-guaranteed capital— aspiring Debenture SBICs must raise a minimum

of \$5 million in private capital. About 60% of private capital invested in venture capital funds is controlled by tax-exempt organizations such as pension funds, foundations, and endowments. Debenture SBICs were created to make loans to small businesses and may only augment their private capital by borrowing government-guaranteed capital through SBA. SBA-guaranteed borrowed capital is treated by IRC §512(b)(4) as “debt-financed property” which carries with it “acquisition indebtedness.” This fact subjects tax-exempt investors who would otherwise be inclined to invest in Debenture SBICs to UBTI liability. For this reason, Debenture SBICs find it impossible to raise capital from tax-exempt investors. Free to choose, tax-exempt investors opt to invest in venture capital funds that do not create UBTI record-keeping requirements or taxes.

Congress designed Debenture SBICs specifically to make subordinated debt financing available to small businesses. Such loans are well suited for family-owned businesses that may never reach the growth required to “go public,” or, for companies whose owners may never want to lose equity or control of their companies by the sale of large blocks of stock. These companies are often found in the heartland of America, not the “hot” locations that typically attract media attention. Nonetheless, these companies are very important to America’s economic wellbeing in general and the health of their local communities in particular. They are often primary employers in the areas in which they are located.

The structure mandated by Congress for Debenture SBICs creates UBTI. Thus, 60% of private capital potentially available to Debenture SBICs is “off limits.” This is in conflict with congressional intent. As found in §102 of the Small Business Investment Act, that intent is

“to improve and stimulate the national economy in general and the small business segment thereof in particular by establishing a program to stimulate and supplement the flow of private equity capital and long-term loans which small-business concerns need for the sound financing of their business operations and for their growth, expansion, and modernization ... provided, however, that this policy shall be carried out in such a manner as to insure the maximum participation of private financing sources.” Emphasis added.

There should be no tax revenue loss associated with the amendment. Tax-exempt investors allocate only a finite percentage of their capital to the class of investments represented by venture capital funds. Allowing Debenture SBICs to compete for such funds on even terms with equity-based venture capital funds will not increase the capital allocated to that class of investments. The government is receiving little if any tax revenue attributable to Debenture SBIC UBTI since tax-exempt investors invest their allocated amounts in equity-based venture capital funds that do not produce UBTI.

That concludes my prepared testimony. Thank you once again for the opportunity to share my views on the important subject of small business access to capital.



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Small Business Investment Company Program Statistics
Fiscal Year 2000 SBIC Data Provided By SBA

| Investments By Type Of SBIC | Number | Total \$ Amount | \$ % | \$ Average | \$ Median |
|-------------------------------------|---------------|------------------------|-------------|-------------------|------------------|
| Participating Security SBICs | 1,613 | 1,458,043,528 | 27% | 903,933 | 500,000 |
| Debenture SBICs | 1,994 | 862,546,615 | 16% | 432,571 | 150,000 |
| Bank SBICs (No Leverage) | 739 | 3,082,858,957 | 56% | 4,171,663 | 1,462,802 |
| Specialized SBICs | 293 | 62,830,564 | 1% | 214,439 | 175,000 |
| Total Investments | 4,639 | 5,466,279,664 | 100% | 1,178,331 | 250,000 |
| Category Of Investments | | | | | |
| Straight Debt | 1,713 | 392,697,531 | 7% | 229,245 | 100,000 |
| Debt With Equity Features | 960 | 1,052,258,835 | 19% | 1,096,103 | 357,609 |
| Equity Only | 1,966 | 4,021,323,298 | 74% | 2,045,434 | 750,000 |
| Total Investments | 4,639 | 5,466,279,664 | 100% | 1,178,331 | 250,000 |
| Investments By Business Age | | | | | |
| Under 3 Years | 2,641 | 3,427,424,798 | 63% | 1,297,775 | 250,000 |
| 3 to 6 Years | 932 | 963,171,136 | 18% | 1,033,445 | 225,590 |
| 6 to 10 Years | 489 | 393,911,316 | 7% | 805,545 | 188,000 |
| Over 10 Years | 577 | 681,772,414 | 12% | 1,181,581 | 300,000 |
| Total Investments | 4,639 | 5,466,279,664 | 100% | 1,178,331 | 250,000 |
| Investments By Business Type | | | | | |
| Technology Businesses | 1,468 | 1,967,860,679 | 36% | 1,340,505 | 500,000 |
| Non-Technology Businesses | 3,171 | 3,498,418,985 | 64% | 1,103,254 | 200,000 |
| Total Investments | 4,639 | 5,466,279,664 | 100% | 1,178,331 | 250,000 |
| Investments In LMI Areas | | | | | |
| Low-Income Areas | 705 | 743,230,215 | 14% | 1,054,227 | 140,000 |
| Moderate-Income Areas | 613 | 608,529,152 | 11% | 992,707 | 203,750 |
| Total LMI Investments | 1,318 | 1,351,759,367 | 25% | 1,025,614 | 193,181 |

Notes:

1. A total of 3,060 small businesses received SBIC financing from 4,639 investments made in FY 2000.
2. SBIC investments were about 48% of all VC transactions and 12% of all VC dollars for the period.
3. The average non-SBIC venture capital investment equaled approximately \$11 million in 2000.
4. Approximately 85% of all non-SBIC venture capital investments are made in high-technology firms.
5. Participating Security SBICs had distributed \$264 million in profits to SBA through April 25, 2001.
6. Small Businesses receiving SBIC financing had an average of 125 employees. The median was 25.

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